ACCOUNTING REFORM AND INVESTOR PROTECTION
VOLUME II

S. HRG. 107–948

ACCOUNTING REFORM AND INVESTOR PROTECTION

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

VOLUME II

ON

THE LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002: ACCOUNTING REFORM AND INVESTOR PROTECTION ISSUES RAISED BY ENRON AND OTHER PUBLIC COMPANIES

MARCH 5, 6, 14, 19, 20, AND 21, 2002

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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C O N T E N T S

VOLUME I

TUESDAY, FEBRUARY 12, 2002

WITNESSES

THURSDAY, FEBRUARY 14, 2002

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

TUESDAY, FEBRUARY 26, 2002

WITNESSES

Page

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

WEDNESDAY, MARCH 6, 2002

WITNESSES

Page

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

THURSDAY, MARCH 14, 2002

WITNESSES

TUESDAY, MARCH 19, 2002

Page

WITNESSES

Additional Material Supplied for the Record

WEDNESDAY, MARCH 20, 2002

WITNESSES

THURSDAY, MARCH 21, 2002

Page

WITNESS

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

VOLUME III

MONDAY, JULY 8, 2002

TUESDAY, JULY 9, 2002

WEDNESDAY, JULY 10, 2002

THURDAY, JULY 11, 2002

FRIDAY, JULY 12, 2002

ACCOUNTING REFORM AND INVESTOR PROTECTION

VOLUME II

TUESDAY, MARCH 5, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

This morning, the Senate Banking, Housing, and Urban Affairs Committee conducts the fifth in a series of hearings on accounting and investor protection issues raised by the problems of the Enron Corporation and other public companies. As the serious and far-reaching ramifications of the Enron situation continue to ripple through our capital markets, and also through our economy, the Committee seeks to identify underlying systemic and structural weaknesses that contributed to the problems, and to seek remedies that will minimize the possibility of future events of this kind.

The failure of Enron raises numerous important issues that have arisen on occasion in connection with other public companies. Among those that have been foremost in the minds of the witnesses at our earlier hearings are the following: The integrity of certified financial audits; accounting restatements; accounting principles and auditing standards; accounting regulatory oversight system; auditor independence; corporate disclosure; the SEC's "selective review" of filings; conflicts of interest; stock analyst recommendations; corporate governance; and the adequacy of SEC resources. And, indeed, other items as well.

In our previous hearings, the Committee received testimony on these and other issues from witnesses with long and distinguished experience in both the public and private sectors. We have heard from five former Chairmen of the SEC; the Chairman of the International Accounting Standards Board, as well as the Chairman of its Trustees; a panel of former SEC Chief Accountants, a former Chairman of the Financial Accounting Standards Board, the CEO of a preeminent pension fund serving the education and research community, and an authority on corporate governance. Our witnesses have offered recommendations for legislative and regulatory measures to address the problems confronting us.

Our witnesses today bring important new perspectives to the issues under consideration. They are: David Walker, Comptroller General of the United States; Robert Glauber, the CEO of the National Association of Securities Dealers, one of the capital markets' principal self-regulatory organizations; and Joel Seligman and John Coffee, two of the Nation's most distinguished law school securities professors.

First, the Committee will hear from Comptroller General Walker, who is the Nation's chief accountability officer and the head of the General Accounting Office. Mr. Walker is a Certified Public Accountant, and formerly was a Partner and Global Managing Director of Arthur Andersen's Human Capital Services Practice. Prior to joining Andersen, he was Assistant Secretary of Labor for Pension and Welfare Benefit Programs and Acting Executive Director of the Pension Benefit Guaranty Corporation.

I should note that last spring, I, joined by two of my colleagues on this Committee, Senators Dodd and Corzine, wrote to the Comptroller General asking him to "review whether the Securities and Exchange Commission's resources are adequate to stay abreast of the market and technological changes that are occurring in the domestic and global financial markets." We specifically asked in that letter "whether the resources available to the SEC are adequate for its ongoing efforts regarding full and fair disclosure, enforcement and investor education." Of course, we have now confronted these major systemic challenges to the workings of the market and they make those questions even more pertinent and relevant. And we look forward to receiving from the Comptroller General the results of the GAO investigation.

We have also invited the Comptroller General to share his views on the oversight of the accounting industry, auditor independence, corporate governance, and related issues.

The second panel will address the regulation of accountants and the advisability of creating a new organization to regulate the accounting profession, as well as such issues as conflict of interest and the proliferation of accounting restatements. We just recently asked the GAO to conduct a study on the "proliferation of restatements of earnings and other financial data which have been issued in recent years by publicly-traded companies."

I will introduce the individual members of the second panel at the conclusion of the Comptroller General's testimony.

Before I turn to you, Mr. Walker, let me turn to my colleagues to see if they have any opening statements.

Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. A short opening statement, Mr. Chairman.

[Pause.]

Chairman SARBANES. Is that it?

Senator BUNNING. No.

[Laughter.]

I won't keep you long, Mr. Walker.

First, I want to thank the Chairman for holding this important hearing and I would like to thank our witnesses for testifying.

It is very important to continue to look at the accounting side of the Enron scandal. We have had some good hearings on the issue already and I know that we have another hearing tomorrow. I am fairly certain that we will have more after that.

The industry has already started to move in the right direction. All of the major firms have now fully separated their consulting and auditing arms, but I think we need to do that permanently. I would prefer to do it legislatively, although the SEC is doing it by regulation. We have to make sure that 10 or 20 years from now, we do not have auditors doing consulting and start the whole process over again. I do not believe that auditors doing consulting caused the Enron collapse. It was certainly caused by greed. But it surely did not stop the collapse.

There are a number of other options that we need to look at on accounting standards. I look forward to hearing from our witnesses. I also am very interested in hearing from our witnesses on what they think of the role of analysts in Enron and what we should do, if anything, about them.

I spent 25 years in the securities business. I am very concerned about the so-called firewalls between the analysts who are supposed to be thinking of their customers first and foremost, and other aspects of a financial firm. We had firewalls at the firm that I worked at, but believe me, I knew what the rest of the firm was doing and so did everyone else.

I am looking forward to your testimony and I thank you for coming before us today.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much, Senator Bunning.

Senator Dodd.

COMMENTS OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman, for holding this hearing. This has been a very, very helpful set of hearings.

Having had a chance to look at the GAO report, this is going to be a very worthwhile document I think in making the case that we have tried to make for some time now. The rationale for asking the GAO to look at this was based on some very strong feelings of inadequate resources and other problems. And as you point out, this is not just a question of resources, but turn-over rates and also the workload we are imposing on the SEC as well, contribute to some of the problems we are facing. But I think this will do a great deal to help us as we try to fashion some suggestions legislatively to deal with the issue.

So, Mr. Chairman, I am appreciative of this set of hearings and look forward to the testimony.

Chairman SARBANES. Thank you very much.

Senator Miller.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. Thank you, Mr. Chairman. I have no opening remarks. But I want to say again, thank you for holding these hearings and I thank our witnesses for being here to testify.

Chairman SARBANES. Thank you very much.

Senator Crapo.

COMMENTS OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman. I also have no opening remarks and again, thank you for holding these hearings.

Chairman SARBANES. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. I have a statement I will put into the record.

This has been a very revealing set of hearings and informative to all of us. I think the report on the increased workload is a very, very positive piece and I appreciate the response and I look forward to your comments on some of the structural issues with regard to how we go forward.

I appreciate it very much, Mr. Chairman.

Chairman SARBANES. Thank you very much. We would be happy to turn to you, Mr. Walker.

STATEMENT OF DAVID M. WALKER
COMPTROLLER GENERAL OF THE UNITED STATES
U.S. GENERAL ACCOUNTING OFFICE
ACCOMPANIED BY: THOMAS McCOOL
MANAGING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT
AND ROBERT GRAMLING, FORMER DIRECTOR
CORPORATE FINANCIAL AUDITS

Mr. WALKER. Thank you, Mr. Chairman, Senators. It is a pleasure to be here today to address certain systemic issues designed to better protect the public interest in light of Enron and other recent earnings misstatements and business failures.

I would like, Mr. Chairman, to enter into the record, if I can, a copy of my full statement, which I think has been provided to you, of which I might note, the last two pages represent a copy of these two charts that I will refer to a little bit later.

Chairman SARBANES. The full statement will be included in the record.

Mr. WALKER. Thank you, Mr. Chairman. In this statement, there are a number of key questions dealing with a variety of elements of our current system that we believe need to be addressed. We look forward to working with the Congress and others in doing that, but let me summarize some of the key points, if I can, Mr. Chairman.

I will not address Enron directly. As you know, there are many players on the field already with regard to Enron. At the same point in time, there are a number of systemic issues I think that are raised by the Enron situation, as well as other recent earnings restatements and other business failures.

There is a need to examine a range of important and interrelated systemic issues. I will touch on four this morning. First, corporate governance. Second, independent audits. Third, the regulatory and oversight structure. And fourth, the accounting and financial reporting model.

I will also touch on the recently issued report on the SEC that you just noted, Mr. Chairman, and I would like to have that inserted into the record as well, if at all possible.

Chairman SARBANES. It will be included in the record.

Mr. WALKER. Mr. Chairman, I am also going to refer to another document that is being released today which represents a summary of a roundtable discussion that we held last Monday with a number of top experts whose names are included herein, to talk about a range of corporate governance, transparency and accountability issues that I would also commend to you and the Members, and would like for that to be inserted into the record, if at all possible.

Chairman SARBANES. Without objection, it will be so included.

Mr. WALKER. Thank you.

In addressing these issues, I would like to note that there are three key principles that, in our view, need to be addressed in order to ensure that any system functions effectively.

First, there needs to be adequate incentives in place for people to do the right thing. Second, there needs to be adequate transparency in order to provide reasonable assurance that the right thing will be done. Third, there needs to be appropriate accountability if the right thing is not done. And these three elements, in our view, relate to the entire testimony, as well as other areas.

I will start with the corporate governance area.

Clearly, serving on a board of directors is an important, difficult, and challenging responsibility in today's times. Boards of directors work for the shareholders and they need to have an adequate number of qualified, independent, and adequately resourced members in order to do their job effectively.

Audit committees have a particularly important role to play in connection with interaction with both internal and external auditors, as well as in connection with making sure that the enterprise has a sound and effective system of internal controls and that they are properly reporting their results in accordance with applicable standards.

With regard to independent audits, external auditors or independent auditors play a critically important role in assuring that our capital markets function effectively and efficiently. External auditors work for the shareholders and they hold a public trust. This trust must not be violated.

Auditors need to be both qualified and independent. While audit firms have the ability to provide a broad range of services to their clients, they should not perform certain nonaudit services given related conflict-of-interest issues.

There are certain nonaudit services that should not be a problem. There are other nonaudit services that do present problems. In this regard, Mr. Chairman, GAO within the last 2 months has issued a new independence standard, which is generally included in accepted auditing standards for the Federal Government entities, the so-called "Yellow Book," in which we have outlined a principles- and safeguards-based approach which we believe provides a sound framework for addressing some of the concerns that have been expressed about auditors performing certain nonaudit services.

We are in the process of providing additional guidance, questions and answers commentary that is necessary in a principles-based approach. We are working with interested parties to do that and are hopeful that the AICPA will end up following the GAO's lead

in taking a similar approach in dealing with a range of other independence issues that are beyond our direct authority to address.

It is very important that auditors focus not just on whether or not the statements are presented in accordance with Generally Accepted Accounting Principles. It is also critically important that they make an affirmative determination as to whether or not the statements are fairly presented in all material respects.

Both of these elements are critical. As a result, auditors have a responsibility to try to assure that there are not material misstatements. They should assure that the financial statements are free of these material statements and in addition, in today's complex and rapidly changing world, it is critically important, both for boards of directors, as well as auditors, that they focus adequate attention on the entity's systems and internal controls. They are critically important.

GAO has for years done additional work on internal controls with regard to Federal Government entities and in fact, we express an opinion on whether or not those controls are effective.

We believe that the same needs to be considered for the private sector, for at least public companies, as to whether or not auditors should have a responsibility for expressing an opinion on these key controls which are becoming increasingly important given rapid changes in emerging technologies.

With regard to the regulatory and oversight structure, these two charts, which are presented as the last two pages of my testimony, provide an illustrated summary of who some of the key players are who are relying on our current system. You have individual investors, institutional investors, banks and lenders or other creditors, and rating agencies, among others.

They are relying upon a wide array of players who have various rules and responsibilities under the current system.

Time does not allow for me to explain the chart on the right, but nonetheless, I think it serves to illustrate that there are a lot of players on the field. It is not always very clear as to what the different role and responsibility of each player is. In some cases, there are overlaps. In some cases, there are gaps. And in some cases, there may be inconsistencies.

In summary, the current self-regulatory system is deemed by many to be fragmented, not well-coordinated, and has a discipline function that is not timely and does not contain effective sanctions. For example, the AICPA's disciplinary function is to kick you out of the AICPA. Well, I am a member of the AICPA and I am a CPA in at least three States, and obviously, I do not want to be kicked out of the AICPA. If I get kicked out of the AICPA, and there is no requirement to join the AICPA, it saves me some annual dues.

I would hardly suggest that that is an effective sanction.

On the other hand, with regard to the State regulatory authorities, the State boards of accountancies, they have the ability to pull my license to practice and pull the certificate of any auditor who violates their standards, the so-called nuclear device. But they rarely, if ever, use that sanction. As a result, we need to understand whether or not we have really meaningful sanctions in order to provide appropriate checks and balances.

With regard to the accounting and reporting model, the current accounting and reporting model is inadequate to meet the needs of the users and it is not properly aligned with our knowledge-based economy in the 21st Century. Accounting must be based on the economic substance of a transaction, irrespective of its form. Additional focus is needed in connection with a variety of value and risk-related factors inherent in our 21st Century economy.

In addition, the timeliness and usefulness of current reporting is also an issue and additional emphasis needs to be placed on key trend and performance-related data.

Mr. Chairman, with regard to our SEC report, which you have so kindly put in the record, in summary, I would say the following.

There is a growing mismatch between the SEC's responsibilities and their resources. Resources are not just financial resources, they are human resources, as well as technological capabilities. There is a need for a comprehensive and integrated plan to address these matters, focusing on value and risk. The SEC's human capital challenge or people challenge is of particular importance given their turn-over rates and the current environment in which they are operating.

It is also critically important that the SEC have a strong, effective and credible enforcement function which will include both civil, as well as criminal penalties in appropriate circumstances.

Our current system, as you know, is based largely on civil sanctions and that is understandable for a variety of reasons. However, when people violate the law in ways that could violate criminal statutes, it is critically important that there be full accountability. You do not have to give very many people wide stripe suits in order to send a strong signal.

In summary, the effectiveness of our current systems of corporate governance, independent audits, regulatory oversight, and accounting and financial reporting, which are the underpinnings of our capital markets and are designed to protect the public interest, have been called into question as a result of Enron and other recent activities.

Many of these issues that are being raised have previously surfaced from other business failures and restatements of financial statements that significantly reduced reported earnings or equity.

The results of the forum that we held last week on governance, transparency, and accountability identified a range of major issues that should be addressed and I have touched on some of those today.

As is usually the case in issues of this magnitude and of this importance, there is no single silver bullet to quickly make repairs needed to the systems that support our capital markets. The fundamental principles of having the right incentives, adequate transparency and full accountability provide a good sounding board to evaluate proposals that are advanced. A holistic approach is also important as the systems are interrelated and weak links can severely strain their effective functioning.

Finally, Enron's recent decline and fall, coupled with other recent business failures, pose a serious range of systemic risks that must be addressed. Effectively addressing these issues should be a shared responsibility involving a number of parties, including top

management, boards of directors, various board committees, stock exchanges, the accounting profession, standard setters, regulatory oversight agencies, analysts, investors, and the Congress.

In the end, no matter what system exists, bad actors will do bad things with bad results. We must strive to take steps to minimize the number of such situations and to hold any violators of the system fully accountable for their actions.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much. Did you want to discuss those charts at all? They are such a large presence in the Committee room——

[Laughter.]

I think we ought to direct your attention to them, if only for a few minutes.

Mr. WALKER. Well, I will give you a couple of highlights, Mr. Chairman.

Chairman SARBANES. All right.

Mr. WALKER. Time doesn't allow going into a lot of depth.

You have several different components of our system on which the public relies. And it is not just the shareholders, obviously, that we are talking about, but it is also the confidence of the investing community and a variety of other parties in our capital markets including the key players that have important roles to play.

There are at least four major elements. You have public regulation. Public regulation, by and large, is done by the Securities and Exchange Commission and by the various State boards of accountancies who regulate the license of independent certified public accountants to practice.

A variety of private-sector or nongovernmental type entities are involved in providing regulatory oversight. In some cases, they are self-regulatory organizations. In some cases, they are professional associations like the AICPA.

With regard to the self-regulatory concept, on the accounting side, you have the Financial Accounting Standards Board, which is noted on the chart. You also have responsibilities on the audit side, which are divided between the SEC, the AICPA, and the Public Oversight Board.

You have other key players which have been alluded to, such as the exchanges, who set certain requirements for being listed on the exchanges, broker-dealers, and analysts who work for those broker-dealers. On the far right, you have our overall corporate governance structure, the board of directors, the audit committees, and the various sub-entities of the board.

There are various codes of conduct and requirements that apply. Finally, the public accounting firms obviously have interaction with a variety of these different parties.

This chart serves to illustrate, Mr. Chairman, that we have a fragmented system. We have a lot of players on the field. Quite frequently, there is not adequate coordination. Timeliness is a question and also the effectiveness of some of the sanctions when there are violations are a real question as well.

I will give you an analogy real quickly, Mr. Chairman.

I used to be the Assistant Secretary of Labor for Pensions and Welfare Benefits, the fiduciary responsibility provisions involving trillions of dollars and millions of individuals.

The IRS had responsibility for administering the tax qualification requirements. Their most significant sanction was they could disqualify a plan. That would have very adverse consequences on employers, on employees, and on a variety of other parties.

As a result, they hardly ever utilized that sanction for understandable reasons. And so, there was a need for more effective sanctions, both civil and criminal, beneath that, in order to make the system work.

The analogy also applies to the State boards of accountancy, in the case of the CPA's, who can pull somebody's license, but there are not adequate enough sanctions and incentives short of putting somebody out of business.

Chairman SARBANES. I understand that the GAO has recently issued an independent standard for Government audits. It says that the auditors should not provide both audit services and material consulting services. Is that correct? And could you describe those rules and rationale a little more fully?

Mr. WALKER. Mr. Chairman, we have issued something dealing with generally accepted Government auditing standards that deals with independence. That is the so-called "Yellow Book." Basically, what we have done is we have taken a principle-based approach.

It is important to note that there are certain types of nonaudit services or "consulting services," that present potential conflicts which need to be avoided. However, not all nonaudit or consulting services present those types of conflicts. So, therefore, what we did was to, through a several year process involving a number of parties, come up with a proposed standard that first relies on two basic principles—that auditors should not perform management functions or make management decisions. And second, auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit. Namely, the subject matter on which they are expressing an opinion.

In addition to that, we provided examples of services that would not violate these principles, as well as services that would violate them. For example, auditors should not maintain the basic books and records on the entity in which they are conducting an audit and expressing an opinion. Under the current AICPA standards, it is possible for that to be done. We believe that is a fundamental conflict and is inappropriate.

At the same point in time, there are certain types of work that auditors can do dealing with the systems of internal controls, et cetera, which would be fine for them to do, which could be above and beyond the audit.

To the extent that an auditor does not violate these standards, we also have incorporated certain safeguards that would provide additional protection not only to shareholders, but also to other persons who are relying upon the independent auditor. I think it is important to note that our standard does not relate to public companies. Our standard relates to audits of Federal Government entities and certain entities that receive Federal funds, not to the

private-sector entities. That is the responsibility of the AICPA and the SEC. We are coordinating with Chairman Pitt and the AICPA in hopes of reconciling some of the differences here.

Chairman SARBANES. Well, you seem to have set the AICPA off because they have now sent out a key alert to all of their constituency here. I just want to quote from some parts of it:

"Thank you very much for your efforts to reach your Member of Congress during the President's Day recess. It is important that you contact your Member of Congress again, and contact your Representatives and Senators.

"As you are aware, Congress continues to focus on the Enron failure and its fall-out. More than 30 legislative proposals have been introduced so far, with more to come. Many of these bills will not move toward enactment and many proposals deal with issues that are peripheral to the CPA profession. However, there is one overriding issue that we must be especially vigilant about—the prevention of a cascade effect if legislation is adopted that is intended only to affect public trading companies or their auditors."

And then they go on later to talk about the recently issued GAO independence standard which applies to Yellow Book audits and so forth. Then everyone is urged to communicate with their Senators and so forth, about the harmful potential.

"This issue has the potential of being harmful in more profound ways than any issue we have faced. Your help is necessary to deflect it before the public and the profession are adversely affected."

That is from the AICPA out to its—I think they call them key persons, the action alert team.

I might note that they have been invited and will be testifying before the Committee next week. So, they have an opportunity very directly in open session to make these points and we look forward to receiving with an open and objective attitude whatever proposals they bring. But I just thought it was interesting to see these alarm bells being sounded here, and I wanted to get some aspects of this into the record.

Mr. WALKER. May I respond real quickly, Mr. Chairman?

Chairman SARBANES. Certainly.

Mr. WALKER. First, I think that the AICPA's statement is clearly an overstatement.

Second, this is not something that GAO started working on as a result of Enron. We have been working on it for over 2 years.

Third, in the profession, there is a tension, the CPA profession. And I am a CPA. There is a tension between the professional side, which I would argue is the public interest side, and the business side or the economic side.

Reasonable people can differ on where you should draw those lines. However, it took decades for the profession to build public trust and gain public confidence. It can be lost very, very quickly.

We believe it is critically important that one of the things that has to be addressed is the independence issue and part of the independence issue is what type of nonaudit or consulting services are appropriate and which ones aren't?

We feel very comfortable that we have struck a reasoned and reasonable balance in that regard. But we look forward to working with the AICPA and other interested parties to answer a number

of questions that have arisen, which is understandable when you have a principle-based approach. We cannot answer every situation. We are trying to get people to rise up and say, hey, do what is right.

It is what I said before about the idea of are the financial statements fairly presented in all material respects? It is not just whether you check the boxes off. Is the bottom line right? Does it pass *The Washington Post* test? Does it pass the Congressional committee test?

Chairman SARBANES. We have been joined by Senators Stabenow and Bennett. I will yield to them briefly if they have any opening comments, and then, Senator Bunning, it is your turn to question.

Senator Stabenow.

COMMENTS OF SENATOR DEBBIE STABENOW

Senator STABENOW. Mr. Chairman, I would just ask that my statement be put into the record and I want to thank you again. I realize that this may not have the same headlines as when Ken Lay and Andrew Fastow come before other committees, but this is where I believe the real work will be done in terms of the future and what is in the best interests of the American people.

So, I want to thank you for this continuation of the hearings.

Chairman SARBANES. Thank you.

Senator Bennett, did you have anything?

COMMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. No, thank you, Mr. Chairman, I do not have a statement at this time.

Chairman SARBANES. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. Let me see if I can weed out what you have said and what you haven't said.

Your recommendations are for governmental entities. What we are really struggling with is recommendations for the private sector, their auditors being consultants and auditing the same books that they are consulting with, financial consultants.

I don't think you can separate 80 percent and let them do 20. In other words, I think there has to be a complete separation for the public to get the confidence back that was lost with Global Crossing or Enron, I find it impossible to believe that an analyst for First Boston or J.P. Morgan or whoever, would not have knowledge that they were in the underwriting group, the selling group, or have a financial position in a security. And yet, they are free to make a recommendation to buy or sell the stock.

What are your solutions to that position? In other words, I need your help in the publicly-traded companies.

Mr. WALKER. I see, let me start with the auditors first. You are correct, Senator Bunning, that our standard only deals with the audits of Federal Government entities and entities that receive Federal funds. However, we believe the principle-based approach, which would say, you must comply 100 percent of the time with this principle-based approach, and in addition, to the extent that you perform certain nonaudit or consulting services that do not violate those standards, again, you have to comply with certain additional safeguards.

We believe that type of approach has the potential to be applied in the public company arena, as well as in other arenas in addition to the governmental arena. I have already talked to Chairman Pitt about it and they are looking at it and considering it as well.

I have also talked to the head of the AICPA because they promulgate independent standards for CPA's, no matter what type of work they do, as well as the State boards of accountancy. They have an interest in this. For example, the Texas State Board just contacted us within the last couple of days and they might be interested in adopting our independence rules in lieu of the current AICPA rules because they see them as addressing some of the issues that need to be strengthened.

Senator BUNNING. What sanctions would you recommend if you think the current standards are inadequate?

Mr. WALKER. I think sanctions are a different issue. I think one of the things that you ought to consider with public companies is not just what you should be able to do and what you shouldn't do. My belief is that one of the biggest problems we have in the current system is the definition of who is the client?

I would respectfully suggest that in the case of the external auditors, the client is the shareholders, not management. The proxy for the shareholders would be the audit committee and that you may want to consider whether or not the audit committee is the entity that ends up making decisions not only on who is going to be recommended to be hired and retained as auditors or discharged as auditors, but also you may want to consider whether or not the audit committee has some role in overseeing these standards. You may want to think about whether or not the audit committee should receive the resources for the corporation to make sure that the right thing is being done by the auditors.

Senator BUNNING. Don't we have a direct conflict here because sometimes, the audit committee is not well informed by the auditors. Therefore, they have been either lied to or distorted audits, audits that are not truthful. And because of the conflict on the other side, we have a direct effect of what audit comes out. Therefore, the board of directors or the auditors on the board of directors that are hired by the audit committee, maybe, are not getting factual truth and they have been distorted and lied to by the auditor because of the other side of the public-held corporation.

Mr. WALKER. I believe that it is important to have qualified, independent, adequately resource members on the audit committee. They have to meet all of those standards. They have to be qualified, independent, and adequately resourced. In certain circumstances, they may need their own staff. They need to have control over who is doing the audit and what resources are available for that audit to be done.

I believe that there should be a mutuality of interest between the audit committee, who is working for the shareholders, and the auditors, who are supposed to be working for the shareholders. But in addition to the auditors working for the shareholders in a public company, they also hold a public trust because the entire system relies upon certain key players to do the right thing. If they do not do the right thing, I think they need to be held accountable.

Senator BUNNING. Accountable, to the point of when they have defrauded, that they be brought before the justice system and taken care of?

Mr. WALKER. My personal view is that most of the sanctions are civil in nature for understandable reasons. But there are appropriate circumstances where criminal sanctions should be imposed.

Senator BUNNING. Thank you.

Chairman SARBANES. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. And thank you to the panelist. This has been most worthwhile. Mr. Walker, we thank you for your work. I have two questions I would like to raise with you. I will try to get through both of them in the time we have.

Your report indicates, as I mentioned in my opening comments, that SEC resources are inadequate. That is a point that Senator Sarbanes has made. We have talked about this over the past number of hearings. The SEC Commissioners have made the point that there is significant understaffing and you highlight the reasons why. Turnover rates, and I suspect a lot of it has to do with parity and pay, just trying to keep accountants and lawyers and analysts that are being offered substantial increases in their annual pay to leave Government and join private firms, I presume, makes it very difficult for people to stay.

What I would like to get at, if I can with you, is what divisions are in most need of additional staff based on your study? Corporate finance? Enforcement? The accountants' offices? I would like to get some sense of where the gaps are here in light of the circumstances that have occurred. Could you shed some light on that for us?

Mr. WALKER. I would like to have Mr. McCool, the Managing Director of the relevant team, come up, who oversaw that work.

Senator DODD. Fine.

Mr. MCCOOL. Senator Dodd, we did not actually——

Chairman SARBANES. Mr. McCool, why don't you identify yourself, name and position, for the Reporter.

Mr. MCCOOL. Yes. Thomas McCool, Managing Director of Financial Markets and Community Investment.

Senator DODD. Mr. Chairman, you cite one example here in the report. You say, for example, staffing limitations and increased workload have resulted in SEC reviewing a smaller percentage of corporate filings and important investment protection functions.

In 2001, the SEC reviewed about 16 percent of annual corporate filings or about half of its annual goal of 30 to 35 percent. That would be one area, for instance.

Mr. MCCOOL. We found that there are issues across the board at most of the major divisions at SEC. I think that we did not necessarily find that one division was more in need or needed more resources of a particular type than another.

I would suggest, however, that I think our work did shed light on the fact that probably corporate finance and enforcement are the areas where the workload has increased relative to resources in a more significant fashion than some of the others.

Senator DODD. How about accounting? I was told there are about 25 to 30 people in the chief accountant's office. Am I wrong in that? Is that number too low?

Mr. McCOOL. I am not actually sure how many are in the chief accountant's office. I am sorry.

[Pause.]

That is about right. That is about right, 25. I am sorry.

Senator DODD. Mr. McCool, a freshman Congressman has a bigger staff than that.

[Laughter.]

Seriously.

[Laughter.]

Chairman SARBANES. Just to show how bad things really are.

[Laughter.]

Senator DODD. It is stunning. That is a stunning number.

Mr. McCOOL. Again, I think it also does reflect what we talked about earlier, about the role of SEC in the system. One of the thoughts would be how you rethink that role, which is part of the larger question.

Senator DODD. All right. In other words, you are not prepared or—some of the examples you cite—what I was looking for was some additional information that may not be in the report, where you get into specific areas that you would recommend that seem to be particularly short.

Mr. McCOOL. Again, for reasons of lack of data at the SEC and the time constraints to gather original data, we were unable to find measures of what were the real impact and where the impact was differentially greater for one division versus others.

Senator DODD. Yes, Mr. Walker?

Mr. WALKER. Senator Dodd, I would suggest that one of the things that needs to be done at the SEC is there is clearly a mismatch between what they are being asked to do and the resources they have to be able to do it.

I would assert that there is a need for them to kind of fundamentally step back and reassess what are they trying to accomplish, how do they measure success, to what extent are they relying upon some of these other players in order to do things that otherwise they might do, to what extent is that reliance justified?

They need to then come up with what do they think are the adequate numbers of people that they need in order to discharge their responsibilities?

It is a comprehensive workforce plan linked to their strategic plan and their role with regard to the overall system.

I also think they need to place additional emphasis on technology. When you look at the number of filings that they receive every year, it doesn't make any difference how many people you have. It is going to be virtually impossible to be able to ever have enough people to do what needs to be done manually. Therefore, they need to be leveraging technology to a much greater extent to identify risk areas that they can focus whatever human resources they have on the areas that likely represent the greatest risk.

We had this problem when I was at the Labor Department where we had 900,000 filings every year on pension and other employee benefit plans. We had people manually going through them. We designed and implemented an automated system that helped to leverage those resources to make them more effective.

Last, it is not just a matter of how much you pay people, and clearly, there is an issue there. It is a matter of on what basis you pay people. In other words, obviously, people that have greater skills and knowledge and better performance ought to be paid a greater amount than other individuals. And I know that Chairman Pitt has talked about the need to pay people more. No doubt about that, and he needs to get adequate funding to get that done.

But he has also expressed an interest to try to relook at how people are paid. To what extent would be variable pay versus fixed pay? To what extent would it be based on factors other than the passage of time and the rate of inflation?

Senator DODD. When you were looking at the SEC, to answer your own first question, are they doing it? There is a new building going up. So there is a new effort here. Are you satisfied that they are, in fact, looking at technology to do exactly what you are suggesting?

Mr. WALKER. We believe that more needs to be done in the work force planning area and the leveraging of technology, given the mismatch between what they are being asked to do and what they have to do it with.

Senator DODD. I will get back. Thank you, Mr. Chairman.

Chairman SARBANES. This is an opportune time, I think, to include in the record, given this questioning, this article from the March 11 *Business Week*—"Can The SEC Handle All This Scandal?—Its Chief Enforcer Faces a Swelling Caseload and a Frozen Budget." This obviously bears very much on what Senator Dodd has been asking. So, without objection, we will include that article in the record.

Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Mr. Walker, welcome to the Committee. We always appreciate hearing from you and appreciate the work you do.

I cannot let the opportunity pass without thanking you and the GAO for the work that you have all done on auditing the various statements that have been made about the Olympics. We understand that you are going to do an after-action report once the Paralympics are over. We look forward to that.

Chairman SARBANES. I think we should congratulate Senator Bennett and the Utah delegation for a job well done with respect to the winter Olympics.

Senator DODD. Mr. Chairman, I actually went out and spent a couple of days. My wife's family is from Utah.

Senator BENNETT. He had the youngest credentialed——

Senator DODD. The only criticism I have is they made my five-month-old daughter be credentialed.

[Laughter.]

There are various explosions that she was involved in, but I did not think——

[Laughter.]

The only threat she posed was to her father in that regard, I might add.

[Laughter.]

But we had a wonderful experience. The people of Utah, the volunteers, there are a lot of wonderful organizations, but the thou-

sands of people who volunteered their time from that State to make this happen—that was the most important feature I saw in the entire event, the volunteers. So, my congratulations.

Chairman SARBANES. Yes. Apparently, their hospitality and their grace drew really terrific plaudits, not only here, but also abroad as well.

Senator BENNETT. Thank you very much. I appreciate that. As I say, Mr. Walker played a role in that, as did his agency.

I would like unanimous consent to put in the record an article that appeared in *The Wall Street Journal* online, "Listing in a Material World," by Andy Kessler.

Chairman SARBANES. It will be included in the record.

Senator BENNETT. I would like to pursue that with you for just a minute, Mr. Walker. Mr. Kessler says we can solve a whole lot of these problems if we define more clearly the word materiality. What is material and what is not?

Senator Dodd and I lived through the Y2K experience and worked with Arthur Levitt. We tried to get disclosure from companies as to where they were with respect to their Y2K preparation. We had some resistance from some companies that would say, well, we do not have to disclose that because it is not material. And both Senator Dodd and I would say, the potential that none of your computers will work and your entire IT system might shut down is not material?

They said, well, the amount of money that we would spend to fix it falls below the percentage threshold of materiality, so we do not need to tell you where we are. And Senator Dodd, particularly in some of the health care issues, was very aggressive in naming those companies that would not tell us where they were.

It was clearly a material fact with respect to the survivability of the firm. Yet because the numbers fit below the percentage threshold that the accountants would look at, we had some problems. Now Arthur Levitt worked with us on that, and there were SEC regulations on that and they were very helpful.

I think the point that Mr. Kessler makes is a good one, and I would like your comment on it, that many times, restructuring of earnings come about because the original statement is judged to be immaterial.

In Enron, there was a little bit of immateriality here, and a little bit of immateriality there. And pretty soon, the old Everett Dirksen statement applied—a billion here and a billion there, and pretty soon, you are talking about real money.

So is this something, in your professional judgment, that could be pursued with profit to get more transparency in all of these statements?

Mr. Kessler makes another point that I will give you, and then I will listen to your response. He said the materiality threshold should be voluntary. If I might read from his article, he said, "Want to stay at 10 percent? Fine, just tell me. Oh, your stock may trade at a lower earnings multiple, though, since no one can trust your earnings. Want to claim a 1 percent materiality threshold? Great, but you better back it up with all sorts of details about how revenues break down, prices, larger customers, and so on."

For his final comment, he said: “Don’t have that much detail at hand about your own company? I would get your number-crunchers on it real quick. And if you do not want to disclose information, stay private, and try borrowing money from your local bank.”

I think these are very significant observations, and I would like your response.

Mr. WALKER. In addition to the issues of who is the client being a fundamental question, I think the issue of materiality is also a fundamental question.

Auditors are supposed to focus on the concept of materiality, not just in quantitative terms, but also in qualitative terms. Some things cannot be translated into numbers, if you will.

I think the idea of trying to focus more time and attention on what is a reasonable definition of that, the idea of trying to couple that with additional transparency to the extent that judgment is being used, then what are the parameters that individuals have chosen as the basis of making that type of judgment, is something that is worthy of further discussion and debate.

Senator BENNETT. Thank you, Mr. Chairman.

Chairman SARBANES. Senator Miller.

Senator MILLER. I will pass, Mr. Chairman.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

I would like to go through a little bit of this chart, if I could, and try to get at the question of who audits the auditors and how that would flow through this method of oversight of the current structure, and is it with a bias of trying to find out whether it is a clear flow of accountability.

Mr. WALKER. Basically, if we focus on public companies, you have the SECPS, which is the SEC practice section, which deals with public companies. And for firms that audit public companies, a peer review must be conducted.

Senator CORZINE. What does the SEC do with regard to——

Senator DODD. Jon, can you pull that microphone a little closer to you?

Senator CORZINE. Can you say what the SEC has to do with regard to the auditing? Is there any oversight function or is there any auditing of the auditors by the SEC?

Mr. WALKER. They have mandated that a peer review be done. But they have basically relied upon the Public Oversight Board as the entity that would actually oversee the peer review process. The Public Oversight Board is an entity that was created through consultation between the AICPA and the SEC.

Senator CORZINE. The AICPA is a trade association.

Mr. WALKER. A professional and a trade association. It has features of both.

Senator CORZINE. Not publicly-chartered, though.

Mr. WALKER. No, it is not publicly-chartered, that is correct.

Senator CORZINE. And does the POB have peer reviews of every audit?

Mr. WALKER. No. Basically, there is a requirement that every major firm must have a peer review on a cycled basis.

Practically, what has happened in the past is that firms hire other firms to do that review.

Senator CORZINE. Every audit or of——

Mr. WALKER. No. It is the system. Basically, what is audited——

Senator CORZINE. So Enron's audits were never reviewed on a peer-review basis by another auditor.

Mr. WALKER. I cannot comment on whether or not Enron specifically was. It has been reported that Enron was not the subject of the initial peer review by Deloitte & Touche, which was the firm that Arthur Andersen had hired to do their peer review work. And since that case was in litigation, I am not sure whether or not they subsequently went back and did anything or not.

My understanding is, no, they did not.

Senator Corzine, what is important here is whether or not they looked at Enron because, by definition, they are going to look at a sample of engagements. They are not going to look at every audit.

Senator CORZINE. Sure.

Mr. WALKER. Part of the question is, on what basis are they picking the ones they are going to audit? I would assert that one of the things that needs to be done, not only by the SEC, but also by the self-regulatory organizations, is they need to have a more risk-oriented approach to determining which ones are going to be looked at, and——

Senator CORZINE. You mean like restatements.

Mr. WALKER. Right. What caused them to occur? What are the factors and how can that be worked into the oversight process, the peer-review process, to minimize, but not eliminate, the possibility of it happening again?

Senator CORZINE. Let me get this straight. POB, through its supervision of the peer-review process, is not looking at an individual audit to see whether the operations of that audit are conforming with the rules and regulations.

To try to pick an analogy, it is not the same thing that you would see from the New York Stock Exchange coming in and looking at a broker-dealer firm to see whether you were complying with capital adequacy rules.

Mr. WALKER. No. The individual firms that—for example, it is my understanding that Arthur Andersen hired Deloitte & Touche. Deloitte & Touche is conducting the peer review on Arthur Andersen. That involves looking at their overall system and it also involves them selecting a number of engagements that they would end up testing. And the POB ends up overseeing the process at a higher level, typically not down to the individual engagement level.

Senator CORZINE. First of all, what is the output of those reviews? Are there any disciplinary or correcting recommendations that come from that process? And are they public?

Mr. WALKER. There are reports that are issued—in fact, if you do not mind, Senator Corzine, I would like Bob Gramling, who is our expert on all the details here, to come forward. He has done the most recent work here and I know there have been some recent changes. So, I would like to have the benefit of his thoughts, if at all possible.

Mr. GRAMLING. I am Bob Gramling, and I am a former GAO employee of 30-some years who retired 2 years ago as the Director of Corporate Financial Audits. I have come back to help the GAO on

a consultant basis here in doing some of this work related to the accounting profession.

The peer review results in publicly-available reports. Also there is another entity within the SEC practice section that is called the Quality Control Inquiry Committee. We did not put all the alphabet soup on here because the poster board just wouldn't be large enough.

Chairman SARBANES. And the room wouldn't be large enough for the poster board.

[Laughter.]

Mr. GRAMLING. The Quality Control Inquiry Committee also looks at the results of peer review and deals at the firm level with necessary corrections or, I should say, enhancements that may be necessary to their internal quality control and assurance system to make sure they are living up to the required standards. In addition, the Committee will look at individual performance in terms of relationship to complying with the auditing standards. The firm will be given a plan of action to address those weaknesses.

There is, though, no disciplinary function there on individual members. If an issue like that were to arise, then that particular case where there is, say, legal action involved in terms of a legal suit, an alleged audit failure, the discipline of the individual members involved, is handled in another place within the AICPA—the Professional Ethics Executive Committee.

Senator CORZINE. The SEC does not have disciplinary responsibility, nor has it delegated disciplinary responsibility directly. It is a self-initiative of the AICPA.

Mr. GRAMLING. Well, that is correct in actions initiated by the self-regulatory system. The SEC does provide oversight over the Public Oversight Board, as well as annually picking certain peer reviews and selective work papers and actually looking at those from its own standpoint of whether the peer review system is measuring up.

Senator CORZINE. Have there been any significant disciplinary actions that are the outgrowth of the SEC's review of the peer review system?

Mr. GRAMLING. I would say the significant disciplinary actions result from the filing of lawsuits.

Senator CORZINE. Thank you.

Chairman SARBANES. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

Thank you, again, Mr. Walker for being here, and members of your staff. I appreciate your service. It was important to hear from you last week in the Budget Committee and I hope our Federal budget will have the same credibility that we are asking of others. So, we have some real challenges ahead of us.

In your testimony, you talk about the accounting industry needing to create the right incentives to protect the public interest. And part of what we are talking about really is cultural. I am wondering at this point what your feeling is about the culture of corporate America. We have heard from others about the incentives right now, the short-term incentives. And I am wondering if you could comment about the culture of corporate America that does or does not allow dissent.

I have real questions about whether or not the culture involved right now allows dissent, or whether earnings management and interest in the short-term profits of the day will win out at this point in time. I know that this is not easy to change. But if we are talking about a large measure of private-sector regulation, it seems to me that there has to be the right incentives to protect the public interest. I wondered if you would speak to this challenge and what you think we should do about it.

Mr. WALKER. There is a major challenge at the present point in time in that there is a real emphasis on short-term results. The market, to a great extent, has penalized entities who have not hit projected earnings.

Although, let's face it, management has the responsibility to come up with what those projected earnings are. There has been a feeling that one has to continue to show growth or profitability in order to continue to grow stock price and shareholder value.

I think that, as I mentioned before, there are some cultural challenges here. One of the key things that has to be focused on is who is the client? What role do each of the respective parties play in trying to make sure that there are adequate checks and balances in the system to make it work? Also certain other definitions such as what is materiality and what is the proper materiality format?

I think the short-term focus is a problem. I think it is a problem, quite frankly, in the public sector, too. At the Budget Committee hearing last week, we talked about how we look short-term versus how we look long-term. What are we going to do to provide adequate incentives, transparency, and accountability to make sure we don't be overly short-term focused in the public sector as well.

Senator STABENOW. I agree with that. In your testimony you talk about the fact that Enron's November 2001 8–K filing restating its earnings acknowledges the fact that their financial reports from 1997 to 2002 did not follow Generally Accepted Accounting Principles and therefore, could not be relied upon.

Now given the fact that this was a bad-faith reporting by Enron and it had such a devastating impact on so many thousands of individuals and, frankly, the confidence in the whole system at this point, should Congress consider creating penalties for corporate leaders or auditing firms who misrepresent earnings?

On the other hand, how might we balance such penalties with the need to encourage timely and honest updates on previous accounting misrepresentations or mistakes?

Mr. WALKER. My personal view is I think that there are actions that need to be taken by a variety of parties, many of which do not require legislation.

You have the SEC, who can do certain things on its own. You have the self-regulatory entities that have the ability to make certain changes. You have the stock exchanges that have the ability to make certain requirements in order to be listed or continue to be listed, if you will.

You have some of these fundamental definitions that I think, quite frankly, would be difficult to legislate, but need to be addressed, like who is the client and what is materiality?

I do think that there are possibilities for the Congress to be involved in certain ways, including to try to make sure that there is

adequate transparency in certain critical areas and that there are adequate penalties if people violate their responsibilities.

Frankly, we would have to do a lot more work for me to get to a level of specificity with regard to what we think the Congress might want to consider doing in that regard. In part, I think it depends upon what others do. In other words, do you want the Congress to be the first resort or do you want to see if others do what they should do and then, if they do not, then take action?

I think we need to work at this in a coordinated manner.

Senator STABENOW. Thank you.

Senator DODD. Mr. Chairman, may I ask one more thing?

Chairman SARBANES. We could keep the Comptroller General here obviously all day. And since we have him here in town and fairly easily available to follow up with, I do want to get the other panel on, a majority of whom have come from out of town. But I will yield to you.

Senator DODD. Just quickly because I did not realize you were a CPA, Mr. Walker, until you mentioned it in your comments here.

Mr. Seligman will be testifying shortly, and I recall him saying, and I am paraphrasing, that the historical calamity of 1929 involved 1.2 percent of the population that owned shares in public companies. Today, roughly 50 percent of the American public do in one form or another. And so, when you face an Enron kind of situation, you get a sense of the magnitude we are talking about.

Which raises the question, without getting into the specifics, and I understand that you cannot do that, but I wanted you to, just for a minute, take off your GAO hat and answer the question that in a sense has been referenced both by Senator Corzine and Senator Stabenow, and that is who arbitrates for the public, in a sense, when you have an Enron-type of calamity?

Just a reaction here to the notion of an independent regulatory organization rather than a POB over here that has raised some serious concerns about the independence. What is your reaction to that, as a CPA now, about having an independent regulatory body rather than this Public Oversight Board?

Mr. WALKER. Without getting into a lot of detail, I can tell you that I believe that steps need to be taken to increase the interaction between the green and the yellow, for there to be more green involvement in order to deal with the public interest aspects of what CPA's are responsible for.

Senator DODD. Okay.

Mr. WALKER. It is more than just the shareholders. But there is the public interest aspect as well.

Senator DODD. That is what I meant by the public. I did not mean just the shareholder because when 50 percent of the American public are engaged is, I think it is the point that Professor Seligman makes, which is a dramatic point, the 1.2 percent in 1929 versus 50 percent today, that there is a lot more at stake in this—public confidence and trust, and who does arbitrate at that particular point on behalf of the public, speaking just beyond the shareholder interest.

Mr. WALKER. Exactly.

Senator DODD. In other words, we need more green on that chart than yellow.

Mr. WALKER. Or at least interaction between the green and the yellow. The green needs to play a more significant role than it does right now. And while, obviously, not everybody owned Enron stock, the fact of the matter is a significant percentage of the American population owns some stock, and their question is—is that me, but for the grace of God? What about the stocks that I own? And that is where you deal with trust and confidence as a system as a whole, rather than just——

Senator DODD. And investigating.

Mr. WALKER. Exactly.

Senator DODD. Thank you, Mr. Chairman. I apologize.

Chairman SARBANES. Well, Mr. Walker, we thank you very much. A great deal of work has gone into these reports and we will work through them very carefully. We look forward to coming back to you and your associates about them as we continue to probe this matter and as we address seeking systemic and structural changes.

Mr. WALKER. Thank you, Mr. Chairman. A lot of good people contributed to this and I appreciate your interest.

Chairman SARBANES. We understand that. Thank you.

Now, we will turn to our next panel, if they would come forward and take their seats at the table.

[Pause.]

Before turning to the panel, I just want to reiterate a point that I made previously. It is my own very strongly held view that the Administration should be seeking now a supplemental budget for the SEC. I think the SEC clearly does not have adequate resources to deal with the challenge that confronts them. Maybe they should re-study their mission and all the rest of it as some people have suggested. But in the very short run, they need to get at it.

They are losing skilled and expert staff because of the failure of the Administration to do the pay parity, which was part of the legislation that this Committee reported out and that was passed. They have a number of positions down there that aren't filled. They have a great deal on their plate, as this *Business Week* article noted when it raised the question, "Can the SEC handle all this scandal?"

While we work through to get these systemic and structural changes, immediately the SEC, it seems to me, should be enhancing its capacity.

Now, we have written to the President urging that they address this budget situation. I intend to repeat that request. But it seems to me that they should be in to the Congress with a supplemental request with respect to their budget to get on about the task.

Our concluding panel this morning has three very able and distinguished people on it, Robert Glauber, who is the Chairman and Chief Executive Officer of the NASD, a self-regulatory organization for securities broker-dealers. Mr. Glauber was Under Secretary for Finance at the Treasury Department from 1989 to 1992. He was the Executive Director of the Brady Commission Task Force which studied the 1987 stock market crash and had a very distinguished academic career on the faculty at the Harvard Business School, and also at the Kennedy School of Government. We are very pleased to have him back with us.

Professor Joel Seligman, who is Dean of the Washington University School of Law in St. Louis. Actually, Professor Seligman joined with Professor Coffee in the classic textbook on securities law, called “Securities Regulation.” He has also written a number of interesting books, including this one—“The Transformation of Wall Street”—we will put a plug in for your publisher here.

[Laughter.]

Then Professor John Coffee, who has been a very distinguished professor of law at Columbia Law School, where he has taught since 1980. Professor Coffee is also on the SEC’s Advisory Committee on the Capital Formation and Regulatory Processes, and on the legal advisory boards of the NASD and the New York Stock Exchange.

Both Professor Seligman and Professor Coffee have been very active in various professional bodies dealing with the financial markets, securities laws, corporate governance, and finance.

We are very pleased to have this panel with us today.

I think, Mr. Glauber, we will start with you and we will just go right across the panel, and Professor Coffee can conclude the testimony this morning.

**STATEMENT OF ROBERT R. GLAUBER
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Mr. GLAUBER. Thank you, Mr. Chairman. I will read a short statement and then I would request that my full testimony be entered into the record.

Chairman SARBANES. Your full statement will be included in the record.

Mr. GLAUBER. Thank you.

Mr. Chairman and Members of the Committee, thank you for this opportunity to testify on the vital, troubling and timely issues of investor protection and accounting regulation revealed by the collapse of Enron.

Let me begin with a quick overview of the NASD—because who we are bears directly on both the substance of what I will be saying and on the usefulness of the private-sector self-regulatory model that we embody.

The National Association of Securities Dealers is not a trade association, but rather, the largest self-regulatory organization, or SRO, in the world. Under Federal law, every one of the roughly 5,500 brokerage firms and almost 700,000 registered representatives in the U.S. securities industry comes under our jurisdiction.

For more than six decades, our mission and our mandate from Congress has been clear—to bring integrity to the markets and confidence to investors. We do this by writing rules to govern the conduct of brokerage firms and their employees, licensing industry participants, and maintaining a massive registration data base of brokers and firms, educating our members on legal and ethical standards, examining them for compliance with the NASD rules and the Federal securities laws, investigating infractions, and disciplining any members who fail to comply.

A professional staff and independent governance provide needed expertise and indispensable credibility. And the standards we set

are not mere trade group best practices, but enforceable regulatory requirements.

As detailed in my written statement, the NASD's history is to a large degree the history of successful self-regulation in the United States. Every brokerage firm in the country that does business with the public must, by law, be a member of the NASD. With a staff of 2,000, 15 district offices, and an annual budget of some $400 million, we touch virtually on every aspect of the securities business and monitoring all trading on Nasdaq and on selected other markets.

By providing this layer of private-sector regulation between the SEC and the industry, the NASD is not only a guardian for investors, but also a bargain for taxpayers. If we did not exist, the SEC would have to increase its budget by roughly two-thirds and its staff by about half, just to pick up all the regulatory duties now performed by the NASD.

It is little wonder that Congress and the SEC throughout the years have repeatedly identified securities industry self-regulation as a national asset worth preserving and enhancing. Of course, our evolution has not been without its false steps.

In 1996, the SEC, in its Section 21(a) report, criticized the NASD in part for putting its interests as the operator of Nasdaq ahead of its responsibilities as the regulator of the entire industry. The NASD responded promptly by carving out NASD regulation and Nasdaq as two distinct corporate entities with separate boards, management, and staff. And since then, we have spun off Nasdaq entirely, selling our last 27 percent stake in the company earlier this year.

As a result, NASD over the past half-dozen years has returned to its regulatory roots with greater independence, resources, and focus than ever before. And I believe that we are in a unique position to contribute to the vital national discussion this Committee is helping to lead on how to strengthen investor protection by improving accounting industry regulation.

Given the limited time, Mr. Chairman, I think the best way for me to do that quickly is to identify the attributes that are key to the NASD's effectiveness from which I have sought to derive some first principles for successful private-sector regulation.

An essential ingredient of the NASD's success is independent, strong governance. At least half our board of governors comes from outside the securities industry and our large, experienced, professional staff is not beholden in any way to the industry.

The NASD's benefits from the combined ability to write rules, examine for compliance, and provide tough enforcement, all under one roof. This consolidation of the industry's chief regulatory functions reinforces our authority, competence, and credibility.

Our governing structure also relies on parties that have the right incentives to insist upon market integrity and investor confidence.

Our board includes representatives of the public, corporate issuers, and institutional investors, as well as brokerage firms that make up our membership. The beauty of this system is that all of these interests, including the brokerage industry, want markets that investors will recognize as fair, efficient, and safe.

This leads to our next key attribute, which is assured funding, from that part of the private sector having the greatest interest in our effectiveness. The right people pay for the NASD's services. Namely, the brokerage firms who know that market integrity leads to investor confidence, which is good for their business.

This steady and sufficient funding means that we can afford the sophisticated technology, techniques, and infrastructure it takes to regulate a fast-charging, technology-intensive industry. NASD's technology budget alone is $150 million per year. No private-sector regulator can succeed without sufficient ways and means.

Next, I cannot overstate the importance of the NASD being empowered to discipline our members with tough public sanctions. Last year, we brought more than 1,200 disciplinary actions resulting in over 800 expulsions or suspensions from the industry.

It is a big stick—the ability to bar someone from earning a livelihood in their chosen field.

In an average year, we levy well in excess of $10 million in monetary sanctions. Already this year, acting jointly with the SEC, NASD sanctioned Credit Suisse First Boston $50 million for violations relating to its allocation of hot IPO's.

I should contrast this with the accounting industry where no Big 5 firm has ever failed a peer review conducted by another.

The lesson is clear—strong private-sector regulation leads to one serious body keeping its industry clean. Weak private-sector regulation leads to one hand washing the other.

Of course, with authority comes responsibility. Just as our members are accountable to the NASD, so are we accountable to the SEC. Strong oversight by governmental regulators protects investors by ensuring that someone is watching the industry watchdog.

Mr. Chairman, this is not the time and it is not the place to prescribe in detail what a new regulatory regime for the accounting industry might look like. But based on our experience in the securities industry, the question can fairly be asked whether a private-sector regulator could help restore confidence in the accounting industry and if so, what are its essential characteristics?

First, the threshold question.

It is my judgment that if properly designed, a new private-sector regulator can make a major contribution by tapping industry resources and insights not available to the Government. To get the best of both worlds, however, these advantages should be matched with tough SEC oversight under the watchful eye of Congress.

So the question becomes how best to obtain these potential benefits. To do so, the new body would need to follow these essential features.

One, a new private-sector regulator should be an independent organization with a sizable professional staff and with sufficient technology and infrastructure to stay apace of the accounting profession. It should seek maximum industry input consistent with maximum industry accountability.

Two, it should have a strong mandate from the Government that sets its structure and empowers its enforcement arm with full authority to discipline the industry. And it should bring under one roof as many of the essential regulatory functions outlined earlier as is feasible.

Three, it should have a governance structure based on enlightened self-interest. Namely, the need for effective auditing to produce numbers that investors can rely on and markets can trust. This implies a board with many of the same parties as the NASD's—reputable corporate issuers who want their financial statements to carry weight, institutional investors, broker-dealers, and the public. Accountants should be a small minority.

Four, it should have assured funding from some of these same self-interested parties, especially those with the biggest stake in the success of the system. Good candidates might be issuers, broker-dealers, and certainly, since they have a major stake in the credibility of their audits, the accounting firms themselves.

Finally, the private-sector regulators should be subject to strong, appropriate oversight from the SEC and from Congress.

Mr. Chairman, I am convinced that even in the accounting industry, where self-regulation has suffered a bad name, there is a vital role to be played by private-sector regulation. Clearly, shaping such a system represents a great challenge, but the benefits to be gained are even greater.

The NASD and I stand ready to help in any way we can.

Thank you.

Chairman SARBANES. Thank you very much.

Professor Seligman.

STATEMENT OF JOEL SELIGMAN
DEAN AND ETHAN A.H. SHEPLEY UNIVERSITY PROFESSOR
WASHINGTON UNIVERSITY SCHOOL OF LAW IN ST. LOUIS
PUBLIC MEMBER, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS PROFESSIONAL ETHICS EXECUTIVE COMMITTEE

Mr. SELIGMAN. Mr. Chairman, I would ask that my statement be entered into the record.

Chairman SARBANES. Your full statement will be included in the record. I want to thank all three witnesses for the obvious work and effort that went into these prepared statements. We appreciate that very much.

Mr. SELIGMAN. Let me paraphrase a little bit of the statement and emphasize certain points.

First, we have the most successful securities markets in the world at this point, which have just been through an extraordinary period where the aggregate worth of securities traded increased 11-fold, between 1981 and 2000. Senator Dodd suggested nearly half of American households today own stock. The challenge before this Committee is to maintain and, indeed, strengthen, that level of confidence in our securities markets.

Second, it is worth remembering that most of the people in the securities industry, in corporations, and in accounting are honest, hard-working, decent people. But Enron and related cases have powerfully reminded us that even a small number of dysfunctional firms can provide enormous challenges to confidence in our system.

Third, it is very, very important to appreciate how complex the relevant regulatory systems involved are. Professor Coffee and I, as was mentioned, coauthor a casebook which has an 1,800-page sup-

plement, which includes SEC statutes, rules, and forms today. It doesn't so much grow, as metastasize from year-to-year.

[Laughter.]

It is very constructive for Congress to play a leadership role here. But it will be important to recognize that the SEC can be terribly important in filling in the details and carrying out the mission you prescribe to them.

I want to highlight the mandatory disclosure system which focuses on the SEC's disclosure requirements, auditing and accounting. I also agree with the point made by Senator Sarbanes that among the most critical needs at this moment is to address a veritable crisis in the SEC's budget.

It seems to me when you look at the Enron case, the two most sobering aspects of it are that the SEC last examined an Enron annual report called Form 10–K in 1997, in spite of the fact that this was a firm that quadrupled in size between 1996 and 2000, and for a variety of reasons, should have received some attention.

I am very concerned that we are meeting at a time when the Office of Management and Budget has recommended, in effect, a flat budget for the SEC next year.

The SEC only desperately needs more staff, but you have to focus on the pay parity issue. That is, how do you hold onto the very best of the staff? It is the SEC employees who have been there 3 years who you can keep up to 10 years, who are the key, I would submit, to strengthening the Division of Corporation Finance, strengthening the Division of Enforcement, and strengthening the Office of Chief Accountant, all of which are vitally necessary now.

With respect to the specific issues before you, I think the focus of this Committee has devoted to accounting standard setting and auditing is particularly appropriate at this time.

Accounting standard setting, which is currently administered by the private organization, Financial Accounting Standards Board, should be sharply questioned at this moment. The notion that transactions as obviously material in retrospect, as the off balance sheet transactions that Enron and other corporations engaged in, were not required to be disclosed in financial statements or notes.

I would submit to you, in looking at the Financial Accounting Standards Board, as former SEC Chairman Levitt so aptly recognized, the big challenge is independence. How do we create a FASB or a new similar Financial Accounting Standards Board which can both focus on how one articulates a fair presentation of financial data and deals with the many detailed standards. And the bottom line, I would submit to you, the key here, as will often be in your investigations, is money. You cannot expect a FASB to operate in a truly independent way without a more assured source of funds than the FASB currently has.

I would encourage you to explore means to legislate some user or accounting firm fee system that will provide to the FASB, or whatever the standard setting is called, true independence.

Enveloping the Generally Accepted Accounting Principles that the FASB develops is the SEC mandatory disclosure system. This too deserves to be under sharp question today. One must ask, how could financial reporting practices sufficient to bankrupt the sev-

enth largest industrial firm in this country, so long go undisclosed? Is this simply an isolated instance of bad disclosure practices, or is Enron suggestive of more systematic failure?

The SEC, under its current chairman, to its credit, has begun to grapple with the latter, more disturbing possibility. In the last few months, it has issued cautionary releases in areas like pro forma financial statements, selection and disclosure of critical accounting policies and practices, and the management, discussion and analysis item. I would urge, however, much more needs to be done.

The last time the SEC systematically reviewed its corporate disclosure system was in the mid-1970's when commissioner, and then private citizen, Al Sommer led an advisory committee on corporate disclosure. It examined the great disclosure issues of the day.

A similar systematic approach is now well overdue. It should focus not only on SEC's requirements, but also on their link to accounting and auditing.

At its core, Enron involved an audit failure. The outside auditor in that case both appeared to operate with significant conflicts of interest and to have been far too beholden to a highly aggressive corporate management. Several aspects of the Enron audit failure deserve particular focus.

First, I would urge, and here I support the testimony that Mr. Walker gave earlier, it is time for a new auditing self-regulatory organization to be created. It should replace not just the Public Oversight Board, but also a positively Byzantine structure of accounting disciplinary bodies which generally lack adequate and assured financial support, clear and undivided responsibility for discipline, and an effective system of SEC oversight.

The success of such a new auditing SRO will be in careful attention to detail. I would particularly recommend a legal structure similar to that in Sections 15(a) and 19 of the Securities and Exchange Act which apply today to securities associations such as the NASD and other self-regulatory organizations in the securities industry, and address in some detail such topics as purposes, powers, and discipline.

Second, a clear scope provision articulating which auditors should be subject to the new auditing SRO and a mandate that the auditors be subject to the SRO.

Third, a privilege from discovery of investigative files to facilitate auditing discipline during the pendency of other Government or private litigation.

Part of the reason auditing discipline doesn't work very well now is it is often held in abeyance while the SEC or the Justice Department pursues a case. It is strikingly different than the more appropriate ways in which the NASD and the New York Stock Exchange, among others, look at such cases.

Crucially, the new SRO's should be permitted, subject to SEC oversight, to adopt new auditing standards that can evolve over time. These rules would be limited by SEC rulemaking and, of course, Congressional legislation.

As with the accounting standards body, a key question involves funding. To effectively operate over time, any new auditing SRO must have an assured source of funding. The most logical basis of

such funding may prove to be a Congressionally mandated fee on covered auditing firms.

The new SRO should draw on the expertise of the accounting profession to ensure technical proficiency, a supervisory board with a minority of industry representatives, and a majority of public representatives may prove to be an appropriate balance. The chair of such board, however, I would recommend should be a public member.

I believe the most significant issue may prove to be who conducts periodic examinations and inspections of auditors. To paraphrase a classic adage—who will audit the auditors?

I would urge serious consideration be devoted to replacing peer review with a professional examination staff in the new auditing SRO. Peer review has been to some degree unfairly maligned. But even at its best, it involves competitors reviewing competitors. The temptation to go easy on the firm you review lest it be too critical of you is an unavoidable one. While the inspection and examination processes of the New York Stock Exchange and the NASD are not panaceas, they suggest a workable improvement.

Finally, it may prove particularly wise to statutorily replicate Section 15(b)(4)(e) of the Securities Exchange Act which can impose liability on a broker-dealer who has failed reasonably to supervise. Particularly in firms with as many offices as the leading auditing firms, a clearly delineated supervision standard strikes me as vital to effective law compliance.

A separate, not mutually exclusive, approach would be to require mandatory rotation of auditors at specific intervals such as 5 or 7 years. I thought that you received thoughtful testimony from the former SEC Chairman Harold Williams on February 12.

I would particularly emphasize, however, the SRO as the most constructive element, if you will, to emphasize.

Third, particular attention has been devoted to the wisdom of separating accounting firm audit services from consulting. One early result of Enron has obviously been an acceleration of this process by voluntary means in the Big 5 accounting firms.

Congress or the SEC should consider whether a statute or regulation should require such separation and if so, how best to define which consulting services and which accounting firms should be subject to the new law or rule.

Finally, a key reform of the 1970's—the board of directors audit committee—has been sharply criticized for its ineffectuality. I was particularly struck by the testimony of the former SEC Chairman Roderick Hills at your February 12 hearing. He concluded with recommendations that I strongly urge you to consider to find ways to strengthen the independent audit committee, to find ways to create an independent nominating committee with the authority to secure new directors and to appoint all members of the audit committee, and crucially, that audit committees be solely responsible for the retention of auditing firms and be responsible for the fees paid.

Thank you, Senator Sarbanes.

Chairman SARBANES. Thank you very much. It was a very helpful statement.

Professor Coffee.

STATEMENT OF JOHN C. COFFEE, JR.
ADOLF A. BERLE PROFESSOR OF LAW
COLUMBIA UNIVERSITY SCHOOL OF LAW

Mr. COFFEE. Thank you, again, Mr. Chairman, and I want to second enthusiastically everything that I have heard on this panel.

I, however, am going to cover a slightly different topic. In my prepared remarks, I also go at length through the structure of an SRO for the auditing profession and I think that is one of the most important things that is before your Committee. But I want to talk about the securities analyst, because I think that has received less attention. Let me start with a simple comparison.

Analysts and auditors basically are very much alike. They both are in the business of serving investors as watchdogs who examine and verify financial information. What is sauce for one should be sauce for the other and it is noteworthy that we already have an SRO covering the analyst in the NASD, and that is an argument for why the other body, the auditor, should be similarly regulated.

Let me take this comparison further.

I think it is true to say, difficult as it will be to accept, that both the auditor and the analyst are compromised by the unavoidable fact that they receive their compensation from those that they are supposed to watch. That is simple but fundamental. It means that there is going to be an inherent conflict always. And in both the cases of the analysts and the auditors, something significant and relatively invisible happened during the decade of the 1990's.

Let me give you just two statistics and then I won't bore you with statistics. From 1990 to 1997, earnings restatements were fairly flat and level and they averaged 49 times a year, publicly-held companies restated their prior earnings. In 1998, that number soared to 98. Then in 1999, it went to 150; and in 2000, it went to 156. That is an over 300 percent rise in just a 2 to 3 year period. Something lies behind that spike because earnings statements are something that companies bitterly resist. They are both painful, embarrassing, and they will trigger often litigation and SEC investigations. But, suddenly, they spiked.

Let me return now to the analyst. There is a study by Thompson Financial, which runs the First Call service, that finds that the ratio of buy recommendations to sell recommendations increased from 6 to 1 in the early 1990's, to the now-proverbial 100 to 1 by 2000.

I personally do not put great weight on what the number is. It is the fact that there was this very rapid change over the decade that again suggests to me that in the case of both of these watchdogs, there was an increasing problem from conflicts.

And my generalization would be that both the analyst and the auditor became more compromised by conflicts of interest as the decade wore on. In the case of the analyst, let me give you again some studies because we all talk about Enron, but to the social scientist, Enron is just one data point, vivid and tragic though it be. But there is a lot more data points that suggest there is a pervasive problem.

With regard to the research securities analyst, there is a study by McHaley & Wolmack that finds that the long-run performance of firms recommended by securities analysts who were associated

with an underwriter were significantly worse than the long-run performance of firms recommended by analysts who were independent of any underwriter. And this was a broad data sample.

By the way, they also found that the market knows this. The market responds much more positively to a buy recommendation from an independent analyst than from an analyst who is affiliated with an underwriter. They tend to discount those recommendations greatly. So the market knows something and I think it is based on real evidence.

Another study by *CFO* magazine finds that analysts who work for full-service investment banking firms, firms that provide underwriting services, tend to make earnings forecasts that are 6 percent higher on average than analysts who work only for independent firms that do not do underwriting, and these affiliated analysts tend to have 25 percent more buy recommendations than analysts who again are not associated with any full-service brokerage firm.

There is more research—I won't bore you with it—but the common denominator in these and other studies is just what you would intuitively expect. Conflicts of interest count and analysts and auditors tend to become compromised by these conflicts, meaning that the analyst who is associated with an underwriter tends to behave differently and more deferentially toward companies that are their clients than independent analysts behave.

That is one line of research. There is one other line of research I want to point you to.

A lot of studies have shown that analysts are frequently pressured and intimidated basically to cause them to temper negative research reports or not to make changes that downgrade earnings forecasts. Sixty-one percent of all analysts surveyed, one fairly large study, said that they had personally experienced threats of intimidation by representatives of management of a client that they had surveyed and did a negative report on. Twenty percent of all CFO's in a study cited by former SEC Acting Chairman Laura Unger, self-reported that they had made complaints to brokerage firms about analysts who put out negative research and asked that broker be somehow disciplined.

Early in their career, the typical analyst learns that negative research reports can be hazardous to your health and many analysts learn that, therefore, they had better be very cautious and better temper what they say. The truth suffers in that process.

Now what regulatory response is appropriate given this description of current reality?

In part, this depends on what the self-regulators are already going to do. The NASD has posed, I think, a very sensible, sound rule, Rule 2711, which has just been proposed, which would try to change some of the internal structure so that analysts no longer report or are responsible to and no longer clear research reports with the investment banking side of the firm.

All of that is desirable. There are a number of exceptions and qualifications in these rules and how this will play out in practice, it is a little too early to predict. But I would have to tell you that, much as I would endorse Rule 2711, it is not going to be a complete solution to the problem. Analysts will always know who is paying their salary and it is the deal side of the firm. Thus, analysts are

not going to be completely objective when they know that their compensation comes from investment banking, and Rule 2711 doesn't change that. There is a basic choice to be made.

One way to go is to take what I would call the radical Glass–Steagall approach and to try to divorce investment banking from securities research. Some people, serious commentators, would recommend that route on the grounds that nothing else will make the analyst independent.

I personally fear that approach. I think we spent 50 years trying to crawl out from underneath Glass–Steagall and its separation of commercial from investment banking. I think it is far more dangerous in this context because I do not believe that securities research is self-sustaining or self-supporting. It can only be financed by revenues that come from the investment banking side. And my great fear is that if we took the simple Glass–Steagall approach of cutting the baby in two, one half the baby is not going to survive and we are going to have far less securities analysts out there, far fewer companies would be covered, and there would be a danger of real social loss, much of a significant portion of the market not regularly followed by securities analysts.

So, I at least would say that I wouldn't recommend that course. Others would. But having aside from that more radical step, I think we have to talk about how we can police conflicts in this field. And I think that there are more rules that Congress needs to encourage.

My suggestion would be not that Congress itself try to write these rules and legislation, but that Congress can pass some legislation, a general instruction to both the SEC and the other SRO's, and there are multiple SRO's, telling them that they should finetune rules that address the following Congressional goals. Congress has done this before in other legislation.

Let me just give you four rules briefly that I think need to be an integrated approach to the problem of conflicts of interest among securities analysts.

First, I think we need an antiretaliation rule. Congress should seek to protect analysts by requiring the drafting of rules, both at the SEC and the NASD, which would protect an analyst who has his compensation reduced or loses his job in retaliation for a negative research report or other unfavorable research. Of course, that involves a very fact-specific issue. Why was the analyst reduced in salary or terminated? It may have been a poor performance.

We have a body that can deal with this. We have an elaborate arbitration system already set up under the NASD and it would be possible to give the analyst recourse to that, possibly with the right to get some kind of penalty, double his salary or double the loss, if there were a demonstration before that panel that he had been the victim of intimidation or of retaliation because of the published research.

That is one kind of approach. There are different ways of going at this, but the goal of an antiretaliation rule responds to evidence that retaliation is there regularly.

Second, I think that we have to address what I call a no-selling rule. This will be more controversial. If we want the analyst to be a neutral umpire, he cannot also be a salesman. Today, the analyst

regularly participates in the roadshows, regularly sells the IPO's to the various clients and institutional investors who attend the roadshows.

That selling is inconsistent, in my view, with the goal that we may have of wanting the analyst to be a more careful, objective, neutral umpire. It also takes the analyst over the proverbial Chinese wall—and I think if we want that Chinese wall, and I agree with Senator Bunning that the Chinese wall can often be permeable—I think we should make it more respected by not allowing the analyst to hop over that wall, participate in the roadshow, and then come back and be an analyst. I do not think you can keep playing those two different roles more or less simultaneously without there being problems.

A third rule, which I won't go into at any length, I think that there is one abuse called the booster shot under which analysts are under great pressure to make a favorable recommendation of the issuer's stock just before stock lock-ups expire. This is because the issuer management is not able to sell its shares at the time of the IPO. They are only able to sell their shares typically under stock lock-up arrangements 6 months later. And there often have been norms that are more implicit than negotiated, under which the analyst puts out a very favorable recommendation just 1 or 2 days before the management of the IPO firm becomes able to sell its own shares.

Recommendations at that point are both dubious and dangerous and I would think that at least those analysts who are related to the underwriter, who are associated in any way with that client, should be prohibited from putting out buy recommendations during the period of time shortly before and shortly after the expiration of stock lock-ups. It is really the important period.

Now, last, and most importantly, I think Congress should ask the SEC and the SRO's to define the term, independent analyst. This has been done by the SRO's for purposes of directors who serve on the audit committee. But if there is one lesson that should be learned by investors, it is that the investor cannot trust reliably the recommendation of a single sell-side analyst—that is, the individual sell-side analyst—but instead, should look at what the consensus is of independent analysts.

I think that could easily be prepared by the industry. If we distinguish between who's independent and who's not and permit only the former to use the term, independent analyst, it will be very simple for the industry, people like First Call, to quickly produce on websites everywhere the consensus of independent analysts.

This is not a disqualification. It doesn't say other analysts could not put out research. I have no need at all to bar analysts from putting out research. I am merely saying that the term, independent analyst, should be elevated so that the public gets greater confidence looking at the recommendations of the independent analyst, who empirically turns out to be more accurate and a better, less biased judge.

I think these are the less drastic alternatives and the less drastic alternatives are superior. They recognize that we want essentially a private system of corporate governance. But in the last analysis, our system of corporate governance relies on the credibility of the

numbers. And those numbers are principally guarded by auditors and analysts and they are probably the most important side of this still-developing Enron story.

Thank you.

Chairman SARBANES. Thank you very much.

I have a few questions and then I will yield to Senator Corzine. Do you have a scheduling problem, Jon?

Senator CORZINE. [Nods in the negative.]

Chairman SARBANES. Mr. Glauber, would you just outline the funding mechanism for the NASD?

Mr. GLAUBER. Certainly. Essentially all of our funding comes from the broker-dealer community. Most of it is raised by assessments on broker-dealers which reflect their size.

Chairman SARBANES. Okay. Now the broker-dealer is required to be a member of the NASD. Is that correct?

Mr. GLAUBER. That is correct.

Chairman SARBANES. And if he is evicted by membership under your disciplinary procedures, he can no longer be a broker-dealer. Is that right?

Mr. GLAUBER. He cannot be a broker-dealer that deals with the public, that is correct.

Chairman SARBANES. So, you levy a fee on each firm.

Mr. GLAUBER. On each firm.

Chairman SARBANES. Related to the size of the firm?

Mr. GLAUBER. Related to its size, related to its trading operations, as well as we levy some user fees that cover the cost of maintaining our central depository of registration information. And we levy user fees on actually new issues. When a company files a new issue, we have to read the prospectus and we levy a user fee on that.

Chairman SARBANES. So that is all an automatic process. They have to pay that as, in a sense, the cost of doing business. Is that correct?

Mr. GLAUBER. Absolutely.

Chairman SARBANES. Well, it is very interesting because one of the things that is obvious in the accounting context is that these people go around with a tin cup trying to beg money to run the FASB and the international group. Volcker is running around now with his tin cup out trying to get funding for these things.

Mr. GLAUBER. Mr. Chairman, I think you are absolutely right. And as I said in my statement, I believe assured funding of this private-sector regulator is absolutely crucial. I think one can look to issuers, to broker-dealers, and to the accounting industry as the source of that funding.

Chairman SARBANES. I want to ask the two academics—this American Institute of Certified Public Accountants action alert that they have sent out has caught my attention here. They talk about the cascading effect and then they raise the specter that restrictions will be adopted that will impact on small- and medium-sized businesses. They say, what would small business clients do if they could not go to their CPA for tax services or other business advice? They would pay substantial additional fees to hire someone else to perform the necessary services. And then they say, Members of Congress have to be made acutely aware of this.

It raises the question of whether, in addressing this issue, we separate out accounting for public companies from other accounting, and whether our focus should be primarily on the accounting for public companies or a structure that in effect, it may be a two-level structure, or a bifurcated structure, however you want to describe it. Could you address that issue for us? Because I am very concerned.

We have the danger here that they are going to get all up in arms to try to forestall very important and needed changes by raising a specter which is really a scarecrow and not a realistic danger, although you can always argue the slippery slope. But the answer to the slippery slope is you just do not go down the slippery slope. It ought not to be used to bootstrap an argument that you do not do anything, at least it seems to me.

Mr. COFFEE. I suggest that the SEC's auditor independence rule was always intended to apply only to publicly-held companies. And I do not know that you need to deal with the relationship between the auditor of a family controlled firm.

In that world, where you have a family controlled firm, you know who the client is—it is the family that owns 98 percent of the stock and six or seven people. And they may well want you to be both the tax advisor and the auditor.

When we have the publicly-held firm, with 150,000 shareholders or more, there is no way to get the true decision from the shareholders who we believe are the client. Therefore, we need a more prophylactic rule in that context to represent the public shareholders who have no voice and no real mechanism. But there is no need to adopt these strong rules and auditor independence beyond the context of the publicly-held company, the company that the SEC has jurisdiction over. And I do not believe the SEC or anyone else has been intimating that they mean to regulate the behavior of accountants dealing with family controlled companies.

Mr. SELIGMAN. I think those points are exactly right. Since the time of the POB and certain experiments in the 1970's, a clear distinction has been drawn in existing auditing regulation between those firms which regularly have clients that appear before the SEC and those that do not.

In suggesting a new SRO mechanism to you, I think that you can address this type of issue through the scope provisions. If you can focus just on the public impact of the accounting profession, the firms that are before the SEC that make up our securities markets, you will have done a great service.

Mr. GLAUBER. Mr. Chairman, I agree completely with the other members of the panel. This is an issue of investor confidence and it is an issue of investor confidence in publicly-traded securities. That is what you ought to attack and you shouldn't be, I think, thrown off the job by concerns raised about the way auditing is done for small family companies.

Chairman SARBANES. What I am concerned with here is an argument is going to be advanced for the small family companies, the conclusion of which will be that we ought not to address the public companies.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

I want to explore a little bit the analogue of Nasdaq with the accounting industry and how FASB fits into that analogue. It is one of the more difficult pieces for me to get a conceptual view about. If I understand it right, Nasdaq does set out standards for behavior and the rules with which markets operate, if I am not mistaken. Is that true, Mr. Glauber?

Mr. GLAUBER. It does, indeed. Since we have just sold our last shares in Nasdaq and are now completely separate from Nasdaq, I want to emphasize that it is the NASD that does the regulation of broker-dealers and, in fact, sets out a group of rules that deal with conduct. It is different from the FASB, the FASB deals with standards. Really, ours are conduct or behavior or ethics rules.

Senator CORZINE. How would any of you comment FASB might fit into a structure where we developed an SRO or an IRO, an independent regulatory organization of some form that fits the analogy of Nasdaq or the New York Stock Exchange for supervision of the accounting industry?

Mr. SELIGMAN. Could I take a stab at that one because I thought about that to some degree.

I really think the distinction between accounting standard setting which could be done under a strengthened FASB with, I would submit, heightened SEC oversight, and auditing, and particularly the disciplinary functions, can be treated separately.

I would submit that what is of clearest analogy between the NASD and a new auditing SRO is the requirement that broker-dealer firms and representatives in effect are subject to the NASD regulation, which is subject to SEC oversight and ultimately, the SEC can independently bring actions as well. When you compare that with the current structure of auditing oversight, there are just too many steps. It takes too long. There is no clear body that has responsibility. The SEC's oversight is attenuated.

To be sure, the SEC, in a parallel way, can bring what are called Rule 102(e) actions and disbar or condition someone from practicing before the Commission. But the initial investigations take so long, that it is almost a dysfunctional process. And I would submit, I think the FASB is largely an issue of independence, largely an issue of revivification of the fair presentation concept, and giving them support through financial means so that they can deal with what will be a lot of detailed rules. I think, in contrast, the auditing discipline function is a lot further from the mark today and needs, in effect, a clean slate and needs an approach similar to what NASD has.

Senator CORZINE. The reason that I think there is reason for debate about this, both parties need funding. Are we going to have separate funding, independent funding sources for FASB and some new SRO?

That is a question, perfectly reasonable. We have two sets of fees, but you may want to all have that combined into one independent source of funding for both FASB and the SRO, if that is the direction you would want to take.

And the second element is, is it possible that the information that one gains, the knowledge, the synergies that one gains from auditing the auditors and the questions that come up and the challenges that are revealed through that process, are the reasons that

you get actions out of FASB with regard to the direct questions that need to have clarification and rule setting and standard setting in the FASB process?

So, I can make the case on the one hand. I can also say that we are making it a more complex structure. I think I am hearing Professor Seligman say that he would separate the two. But I would love to hear the other witnesses and their pros and cons.

Mr. COFFEE. Let me add one word to this, if I can. I think I also am happier with the relative insularity of the FASB. If FASB was immediately subject to the control of the SRO body, it might be forced to make changes more quickly than we would like. For the future, the problem with debating FASB standing alone is that——

Senator CORZINE. We do not have that problem now.

Mr. COFFEE. Well, the problem in the future is that there is something else called the International Accounting Standards Committee. And FASB is part of the process of reaching uniform international accounting standards which is going to transfer, I think, the most critical decisions to the International Accounting Standards Committee.

So if you really want to raise the standard setting issue of where standard setting belongs in this total structure, you have to focus at least as much, and probably more, on this international body in London, the International Accounting Standards Committee. And for that reason, I think that I would advise you as a matter of prudence, do what you can today because dealing with FASB really doesn't for the future resolve the standard setting process.

Chairman SARBANES. We had Sir David Tweedie, who is the Chairman of the International Accounting Standards Board, here to testify before the Committee.

The European Union, apparently, by 2005, will adopt the standards, or it is expected to adopt the standards of the International Accounting Board. That is a powerful economic player worldwide, the European community. So, we are moving toward this situation where there is going to be this standard, the international standard that applies in the European Union. And I guess the United States—I do not know where our standard will be at that point. But the old game where our standard was the standard and everyone else had to follow it, is going to be, it seems to me, impacted by that, once you have a body of the economic size of the European Union with a set of standards.

Excuse me. Go ahead, Jon.

Senator CORZINE. I am curious about this funding arrangement as well. I am sympathetic that there are problems, or at least concerns that one could have by having FASB, the rule setter and the auditors on a regulatory basis combined. I can see where that is.

My own experience with the New York Stock Exchange and the NASD is that those are combined functions, although it is not a perfect match. But I am concerned on funding. You are going to end up with two separate, additional charges which are going out to some element of our economic system. I think we are going to get a lot more letters like the Chairman is mentioning about how burdensome we are now, creating a structure that will impose on the very viability of a lot of companies. Does anyone want to comment on that?

Mr. SELIGMAN. I think I am troubled by the fact that FASB's funding, to some degree, comes from the organizations that will be subject to FASB's regulation, that there have been threats from time to time that if a rule is adopted that the issuers or registrants do not like, they will cut off the funding. And that just doesn't work. You have to have a more automatic mechanism.

I sympathize with your point that it is complex, that there will be more than one charge, in all probability, that there will be more than one ultimate treasury here, but that is the reality today. When you go public with a corporation, you will end up with fees to the SEC, to the NASD. You will have registration fees on the securities exchange, conceivably, as well as NASD. The question is, how can we get the most effective overall body of regulation?

Mr. GLAUBER. I think a tolerable argument can be made to keep the FASB separate. But you raise the two correct issues. First of all, the funding. And think, clearly, there, it has to be some kind of automatic funding so that it is not subject to challenge. And the second is governance, so that you can make certain that the FASB functions as an independent operation and it has not always succeeded in doing that. That is just what Professor Seligman said. If you are going to have it stand separately, you have to have some kind of governance in place to protect it.

Chairman SARBANES. Professor Seligman, you said that it was the difficulty of getting the money to fund the operation from the people that are being regulated. If they do not like it, they won't pay the money. But NASD gets the money from the people that they regulate. The only difference is that it is a mandatory requirement. It is just like lawyers who have to pay into the bar association that runs the grievance process. So it seems to me, as long as it is mandatory or automatic or required, we get over that hurdle, don't we?

Mr. SELIGMAN. One hopes. But that is clearly the direction that you have to go.

Senator CORZINE. Does the SEC, given the overall mandate and mission, even though maybe we ought to step back and have a strategic planning session with regard to what the SEC does, does it have the wherewithal to adequately supervise FASB?

We are the 25 accountants that we heard about in the accounting division, to really be plugged into the supervision and oversight of FASB, to make sure that it is moving forward?

Mr. SELIGMAN. I think that needs to be augmented. Clearly, it will be much more of a priority for the Commission in the next couple of years. But you need more staff in the Office of Chief Accountant and you need high-quality staff.

Mr. COFFEE. I think you are hearing from all of us that the SEC is resource-constrained and I think the less visible casualty of that are the offices such as the Office of Chief Accountant, where you cannot really measure the output until a scandal like Enron comes along, and you suddenly say, why did they ever think that even 3 percent was enough? Now that is a strange, bizarre feature of Enron that you say, 3 percent equity, even if you had that much, it still is a glaring failure of disclosure to the market.

Senator CORZINE. Can I ask one other?

Chairman SARBANES. Yes, go ahead. We may turn it into a free-form here.

[Laughter.]

Senator CORZINE. I apologize for the follow-up on this FASB issue. I think that this is actually one of the more difficult calls.

An IRO or an SRO seems sensible to me. I wonder whether we are going to miss some of the synergies that come from looking at the real problems of auditing, actual auditing statements and what are questions that come up, and whether you will get the kind of resources for the SEC to be able to stay on top of that FASB process, which has apparently not occurred as effectively as people would like.

Chairman SARBANES. Now, Mr. Glauber, you all combine the two, don't you?

Mr. GLAUBER. We write rules which are mainly rules of behavior and ethics. We do not have something which is equivalent to a standard setting like the accountants. If you look at the kinds of rules that we write, they are rules of quality control and behavior, conduct.

Chairman SARBANES. Well, who writes the standards?

Senator CORZINE. That is not entirely true, is it? If I go back to my experience of 1996 and 1997, we set up some specific rules in NASD with regard to both standards and procedures, with regard to spreads and over-the-counter markets and how they actually operate. It is very much similar in some ways to the kinds of standards that one might put down with regard to accounting rules. It wasn't law. It was sort of——

Mr. GLAUBER. Rules.

Senator CORZINE. They were rules that people had to abide by, unless I am mistaken.

Mr. GLAUBER. No, that is perfectly correct, Senator. They are. And if you want to characterize those as standards, then I think you are quite right. I think they are not quite the same thing as accounting principles, and that is why it is very difficult.

Senator CORZINE. I am quite in concurrence that we have different functionalities going on here, so you are going to have little differences in analogy.

Mr. GLAUBER. Yes.

Mr. SELIGMAN. Senator, if I could just add, the current structure of NASD is to separate the standard setting from the NASD reg, which is the enforcement arm. But your point is well taken. It is not essential that it be done that way. If you separate them, you obviously have to have effective coordination. I would submit to you, the key, though, is however you structure it, you need to focus on independence and insured sources of funds.

Senator CORZINE. I think we are all in agreement there.

I have one question for Professor Coffee.

I appreciate the kinds of commentary you are making with regard to security analysts and, in fact, I have seen some of that intimidation that you are referencing. But you did not speak to the rating agencies which play almost an equally important analytical role and commentary and observation. I think if you put statistics down with regard to the independent rating agencies, you ended up

with results that weren't a lot different than what you saw from your so-called conflicted investment banking analysts.

Mr. COFFEE. I think the level of conflict and the level of compromise is somewhat less. But the fundamental fact is there in all three of these cases—auditors, analysts, and debt-rating agencies are all paid by the people they are supposed to watch and does not create the absolutely optimal incentives that you would like.

I am not sure in the rating agencies that I have a simple solution for you at this moment. It is possible that there could be heightened liabilities, but I do not need to necessarily endorse that.

I don't know that either the rating agencies or the securities analysts should be exposed to massive class-action attacks. I think more surgical remedies, such as dealing with the process and dealing with the particular prophylactic rules you want to adopt are better than just always universally heightening liabilities.

Senator CORZINE. I think that is one of the positives of, hopefully, our efforts in this Committee and the Congress, is to come up with some rules of the road that actually do not make it a legal courtroom process to bring about enforcement or redress, but where the rules of the road are actually laid out ahead of time and people then have a disciplinary process.

Mr. COFFEE. Let me suggest this. Although there has been a good deal of study of what has gone wrong with securities analysts, and we have found out that independent ones behave better than ones that are associated with the client, there has been very little empirical investigation of the debt-rating agencies. I think that, there, the information basis for a quick solution is right now lacking. It may well be that you want the SEC or someone else to conduct a more thorough study.

Chairman SARBANES. We will keep going here because this is a very helpful panel. On the analyst issue, I wanted to ask this question. First of all, Professor Coffee, I am not sure here. You said that you had some analysts that were not connected with investment houses. Then later, you said you could only finance the securities research from the investment side. So, you could not really create some bright line of separation because then you could not function. How do I square those two?

Mr. COFFEE. Okay. What I am telling you is, you could certainly have a rule under which analysts could only work for brokerage firms that did not do underwriting. There are such firms. Names like Sanford Bernstein stand out as independent analyst firms.

If we adopted such a firm, I think the consequence of it would be a very sharp reduction in the number of analysts who would be employed in this industry because most of the revenue that supports research analysts comes from the sell side. This is a consequence of the very desirable ending of fixed brokerage commissions back in 1975. It made the brokerage commissions so thin, that I do not think that they are able to support from the buy side the analysts who are employed in these firms.

The consequence would be that we would still have the Sanford Bernsteins and many other such firms, but we might have a reduction in the total number of analysts by a very large fraction. And I think that this would inflict a social injury because we would have less firms follow.

There is the bottom side of the Nasdaq market right now that is very thinly followed by analysts. And if we reduce that population by half, we would have a darker, less transparent market.

Chairman SARBANES. Did you want to add to that?

Mr. GLAUBER. I would like to underline what Professor Coffee just said. I think the consequences of a surgical solution, a Glass–Steagall type solution of separating security analysis from investment banking services, would be a very substantial reduction in the amount of information available to investors. I think a better approach is, indeed, the right kinds of rules imposed by the NASD and others. We have just, as Professor Coffee said, put out what is a very comprehensive and very tough rule. Some of the proposals he made, I hope he will include in comments on that rule. The rule is presently out from the SEC for comment.

Chairman SARBANES. You mean these four suggestions he had here, like the booster shot, for example.

Mr. GLAUBER. The antiretaliation provisions. Because they are very useful alternatives to consider as part of that rule. But I think the best, most effective way to approach this is through rules.

Chairman SARBANES. How about disclosure? Is it adequately disclosed now that the analyst is connected with a firm that is doing underwriting as well, and therefore, you should perhaps take his recommendation with a grain of salt?

Mr. COFFEE. Well, as he will point out, Rule 2711 also addresses the disclosure that should be given. I think that is also desirable.

Chairman SARBANES. Does that address the analyst's own holdings as well? And that was not heretofore the case?

Mr. GLAUBER. That is correct. What it does do is require disclosure by the analyst of his holdings and it requires a disclosure by the firm of its investment banking relationship.

Chairman SARBANES. You may do a lot of good if the analyst has to say up front, my firm is underwriting this company and I own this amount of stock. You are going to look at it and say, what kind of recommendation is this? You will, presumably, discount it.

Mr. GLAUBER. We believe that disclosure plays a very important role. The rule contained both of these disclosure provisions, including, I might add, one in which the analyst has to publish a history of the price of the stock, together with his or her recommendations superimposed on that price history, so that you can see where the analyst was saying buy and where the analyst was saying sell.

I think disclosure plays a very important role and then there are specific prohibitions. For example, no pre-IPO stock. The analyst cannot receive cheap stock as part of his compensation. I think those together are a very effective rule. It perhaps could be embellished and that is why I hope that Professor Coffee will add these suggestions to his comments.

Mr. COFFEE. All I was suggesting, Senator, was that it is difficult for the individual investor to go through all the boilerplate that you are likely to get, even under a much-improved system. And if you were to define a term, like independent analyst, and say only analysts who have met the following standards. I would say the first standard is, you are making a recommendation about a company that your firm has no economic relationship with.

Now there are many in the industry who would disagree and say analysts are independent, even though their firm is underwriter.

I think we would give a lot more value to investors if we tried to define a simply understood term, independent analyst, and say that you can only use that term if you meet the following qualifications. That condenses the disclosure to the bottom-line fact that I think is most important to the investor.

Chairman SARBANES. I want to ask two more questions——

Senator CORZINE. Mr. Chairman, I have to leave. I would make one observation. I do not think this should be limited just to underwriting. The relationships that drive some of those retaliation actions, some of the interests go well beyond. Actually, they are more subtle.

Mr. COFFEE. I certainly agree with you. I did not mean to limit it that way.

Mr. GLAUBER. Absolutely.

Senator CORZINE. We have to be careful about the characterization of only tying it to IPO's or——

Mr. COFFEE. I agree entirely with you. That is why you need a rule-based approach, because only an agency can draft those full rules.

Mr. GLAUBER. That is right.

Chairman SARBANES. Let me ask two more questions.

One is, in the Enron situation, we apparently have instances in which banks extended loans to Enron in very substantial amounts because it was then being connected to the possibility of underwriting or other business that would flow from Enron to the lending institution.

Now, we went through this Glass–Steagall thing here over a sustained period of time. And in the end, you used the phrase, came out from under it, or something. In any event, now we have this situation where this issue has now come before us. What is your reaction to that?

Mr. COFFEE. Well, we each may have different reactions.

Chairman SARBANES. No, no. You do not all have to have the same reactions.

[Laughter.]

We invite different reactions.

[Laughter.]

Mr. COFFEE. I think we have two distinct problems here. One is the problem of the Chinese wall, while necessary, sometimes can work to the injury of the public investor.

This is where the investment bank or the commercial bank has gone out and found investors for private equity deals, such as the private partnerships that were involved in the Enron story. And pursuant to that, you learn a lot of nonpublic information, none of which ever reaches the public side of your firm, which is making recommendations to investors. And one of the ironies and problems is that you may be touting a stock that one half of the firm knows is a very risky, highly leveraged firm. That is a problem that the schizophrenia within the firm doesn't work to the best interests of the investor and I think it needs some further study.

The other problem you are raising is that a lot of banks felt pressured to raise this equity or to form these services in order to be

first in line to serve as commercial lenders. And I think that is a problem, but I actually do think that banks are capable of protecting themselves and you should focus more on the problems of the public investor, who is not as capable of protecting himself and doesn't know that there may be very adverse information that is not reaching the market because of this partial penetration of the information through the firm.

Mr. SELIGMAN. If I can just amplify the first point that Professor Coffee made.

There were some very troublesome journalistic stories and some intimations in the Powers report prepared about Enron to the effect that different financial data was provided to private investors, I believe including banks, than was being made publicly available.

Now this may be effectively addressed by enforcement actions of some sort. But this is an issue which I think is worth exploring with Chairman Pitt when he testifies before you, and addressing how it can be possible that, at least if the newspaper accounts are accurate, that nearly simultaneously, the assets described publicly were only about two-thirds of those that were being described privately. I do not understand how you can reconcile those data. It is plausible. There may be ways to do it. But it hasn't been presented in a way that makes sense to date.

Mr. GLAUBER. Well, let me return to the second issue. That is, the commercial pressures between the commercial banking side and the investment banking side or underwriting side of now these complex institutions.

Chairman SARBANES. Right.

Mr. GLAUBER. I think the pressures flow both ways. The pressures may be, indeed, to offer a loan as a way to perhaps encourage the investment banking services. Those exist. One hopes, and I believe that, over time, the managements, for their own commercial interests, will manage the sets of tensions and pressures because, to make a bad loan in order to get the investment banking business, is just a very bad commercial decision. I believe that they will find a way to manage those pressures, and the shareholders will demand that they do. But it is the early stages of having both of these under one roof and mistakes will be made, I am sure.

Chairman SARBANES. Let me ask you this question. This is a broader question. It is fairly clear that the existing structure, had it worked or had the will been there to be strong or tough or however you want to phrase it, they could have done a lot of things that—I mean, the exchanges could have had listing requirements or the SEC could have pushed the exchanges to have had listing requirements.

The SEC itself could have done a host of things. FASB could have done standards, on and on and on. Of course, the way the system works, FASB is thinking about doing a standard and the next thing you know, everyone is beating down FASB's door, including Members of the Congress, not to do the standard.

Now, everyone's saying, FASB should have done this standard. Where was FASB? Why didn't they do the standard we needed? FASB is moving to do some standards. The exchanges, I think to their credit—we had Ira Millstein in here on the audit committees

and they are making, as I understand it, some constructive changes with respect to audit committees.

But one of the decisions we are going to have to face, or judgments, is how much we have to move in with legislation—well, one area, and Senator Corzine was focusing on it, is what structural changes we need, systemic changes, like with an SRO for accountants that is different from the current because the current thing obviously is not working.

The other question is whether we have to move in with standards of some sort on the argument, this is the only way we can prevent sliding back. Maybe the current regulatory arrangements will do these standards, but maybe not. Or maybe if they do them later, they will fall back from them. It is kind of a broad, somewhat vague question, but I would be interested in getting your perceptions of that issue.

Mr. GLAUBER. Starting from the left and working to the right, I guess.

[Laughter.]

Mr. COFFEE. I think the priority should be on the governance of auditing. I think that is the demonstrated failure, the data about the number of earnings restatements and the way in which earnings management peaked in the late 1990's, should give you the number-one priority, focusing on creation of an SRO.

Now your second point, which I agree with, is that there are times when one way that Congress can interact with SRO's and other bodies, is to give them standards for their future rulemaking.

This would not impose a fine-tune obligation, but you could tell the SRO's that you want them to address in rules the problem of conflicts of interest among research analysts or you want them to study and direct and adopt appropriate rules to deal with enhancing the objectivity of analysts and disclosing any possible biases.

I don't think that really hurts the SRO's. It tells them this is a Congressionally mandated priority and it leaves the front-line problem of drafting, of making things work, in the hands of the body with the greatest expertise, either the SEC or the SRO.

I believe there are things you can do, but I would be cautious about trying to cut through the Gordian Knot with a single stroke, such as by legislating the complete separation of securities research from investment banking.

Mr. SELIGMAN. I mentioned earlier Section 15 and 19(a) of the Securities and Exchange Act. I think that gives you a useful model in response to your very thoughtful question.

It seems to me, at a kind of constitutional law level, there are certain principles you should delineate. You should require a new SRO to be created and you should require it to register with the SEC. You should have in place an adequately funded SEC staff, whether it is in the Office of Chief Accountant or otherwise, that can carefully review the filing with the Commission to ensure compliance with the standards you have established.

There is a great deal of highly detailed work and fine-tuning that will have to evolve over time, subject to SEC oversight. When you periodically have the Commission before you, you can question whether they are doing it well enough. But to try to delineate all of that level of detail, I think would be unwise and too rigid.

Chairman SARBANES. Mr. Glauber.

Mr. GLAUBER. You have now three, between you, Mr. Chairman and these two gentlemen, wise lawyers discussing this issue. I am not a lawyer.

Chairman SARBANES. It puts you at an advantage.

[Laughter.]

Mr. GLAUBER. I tread here very, very lightly. I think that what Professor Coffee said is right. The Congress could easily sketch out some broad principles that it wanted. But I hope that it would not get into the position of writing detailed rules.

This is a fast-changing scene that requires flexibility and I think the right way to get rules written is through either the SEC or some independent regulatory organization that would be created. So, I just would simply encourage you in that direction.

Chairman SARBANES. Well, one of the first things that I did when I became Chairman was to begin an oversight process. I do think that there is much more that the Congress can do in terms of oversight to make sure that the regulatory authorities are anticipating and measuring up to the problems.

That is actually where this drumbeat that we continue to sound about giving adequate resources—you put the SEC out there as a front-line agency for all of this, we call it the jewel in our regulatory crown. It has an incredibly distinguished history over the years. We constantly brag about the integrity of the American markets and how integral this has been to our economic success and how it commands worldwide respect and everything.

Then the very agency who carries the prime burden for all of this is so short-changed in its resources—we have not had a witness yet who has come before us who has even entertained the idea of arguing that their existing level of resources is adequate to their task. Now, they may differ about how far we ought to go, but no one has come in and said, oh, no, they have plenty of resources. That just underscores that situation.

Well, gentlemen, you have been enormously helpful. I hope, as we work through this, we can come back to you for further counsel because we think that that would be very helpful.

Let me simply say, tomorrow, we will have a further hearing. We will be hearing from: Shaun O'Malley, who is Chair of the 2000 Public Oversight Board Panel on Audit Effectiveness, the so-called O'Malley Commission; Lee Seidler, who is Deputy Chairman of the 1978 American Institute of CPA Commission on Auditor's Responsibilities; Arthur Wyatt, Past President of the American Accounting Association; Professor Abraham Briloff, Professor Emeritus of Baruch College of the City University of New York; and Bevis Longstreth, who is a member of the O'Malley Commission and a distinguished member of the SEC.

So this panel will, in a sense, follow along very much with some of the issues that have been developed here today.

Thank you all very much.

This hearing is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JON S. CORZINE

Mr. Chairman, thank you for holding this hearing.

In the wake of the Enron debacle, Congress has an enormous responsibility to take a careful look at the factors that contributed to the company's precipitous fall.

Enron Corporation, along with other high-profile business failures, and the growing discomfort with reported earnings restatements, have highlighted the need for a comprehensive review of our financial reporting system and the regulatory structure that supports it.

For the past few decades, Washington has been focused on deregulation and the development of pro-business policies. Often, these policies have been necessary to adjust for excessive rigidities in our regulatory structure.

To be certain, deregulating our financial system has had many benefits, including the democratization of the market. Productivity has improved dramatically and we have created millions of new jobs. That said—excesses accompanied the good—and once clearly defined boundaries have now become blurred.

The pendulum seems to have swung too far. And as we have heard from many of our witnesses, the culture of business has increasingly become a culture of excess.

Mr. Chairman, with occurrences like we have witnessed at Enron, Global Crossing, Tyco, and PNC Bank, more and more investors are becoming uncomfortable with what they perceive to be a lack of full disclosure in financial statements—those concerns ultimately hurt our markets. And they highlight the glaring need for the SEC to be better prepared, better funded, and better staffed in order to fulfill its enormous mission. We will hear about the challenges the SEC confronts as a result of their increasing workload shortly.

It also shows the need for an improved regulatory structure, one that provides sufficient checks and balances and promotes the integrity of the audit function. A structure that provides the SEC with the resources it needs, and provides independence to the Financial Accounting Standards Board, so that it too may be better equipped to serve its vitally important purpose.

Mr. Chairman, in holding these hearings, I hope we will seek to find out not only "what happened," but also move forward with a plan to diminish the increasing pressures on companies to "play in the gray."

Last week, Senators Dodd, Stabenow, Johnson, and I introduced legislation to address many of these issues.

Mr. Chairman, we look forward to working with you, and the other Members of this Committee to bring a bill before this Committee that will not only provide investors with greater confidence, but also restore credibility to the accounting profession and ensure that the SEC is able to fulfill its oversight responsibility—and has the resources to do so.

The train wreck has occurred. And now that it has, we have a responsibility to ensure that it never happens again.

I look forward to the testimony of our witnesses.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman. Let me begin by commending the thorough approach this Committee is taking under your leadership.

While the work of this Committee may not attract the headlines that we see when the Ken Lays and Andrew Fastows of the world are subpoenaed to appear before Congress, I believe that the careful and deliberative work of this Committee is what will ultimately reform the shortcomings in our current accounting system.

Mr. Chairman, I have approached the issues before us with an open mind and have no predetermined conclusions. I appreciate the interesting and diverse opinions of the witnesses we have had so far. I welcome the witnesses before us today.

We need to continue to explore the serious policy questions at hand.

In particular, we have heard repeatedly that there is a culture of gamesmanship where earnings management is commonplace. We should explore this issue further. Changing a culture is a lot more complicated than changing the law.

In addition, I hope that we will continue to examine: The issue of the best oversight mechanism for the accounting industry; how an oversight board, as well as the Financial Accounting Standards Board should be financed; and, what should be done about perceived problems in the accounting industry's long-standing peer review process.

I also think it is worth exploring what should be done to help whistleblowers who are trapped in a corporate culture that discourages dissent, and to ask what more needs to be done to promote investor education.

All of these issues are complicated. There are differing points of view on many of these matters and we must carefully consider how best to proceed. However, I have every confidence that by working cooperatively, we can put an end to the problems in the industry and we can reassure the American people that our securities market is the best in the world.

Thank you, Chairman Sarbanes.

PREPARED STATEMENT OF DAVID M. WALKER

COMPTROLLER GENERAL OF THE UNITED STATES

U.S. GENERAL ACCOUNTING OFFICE

MARCH 5, 2002

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss with the Committee my perspectives on some of the issues that are now receiving extensive national interest following the rapid and unexpected decline of Enron Corporation (Enron) and the resulting huge losses suffered by Enron's shareholders and employees. The rapid failure and bankruptcy of Enron has led to severe criticism of virtually all areas of the Nation's financial reporting and auditing systems, which are fundamental to maintaining investor confidence in our capital markets. At last count, 12 Congressional committees, the Department of Justice, the Securities and Exchange Commission (SEC), and the Department of Labor's Pension and Welfare Administration all have ongoing investigations of Enron. The individuals responsible for the Enron debacle should be held accountable for any misdeeds. At GAO, accountability is one of our core values and must be a critical component of any system in order for it to function effectively.

The facts regarding Enron's failure are still being gathered to determine the underlying problems and whether any civil and/or criminal laws have been violated. Therefore, I will not comment on the specifics of the Enron situation and who is at fault. At the same time, the Enron situation raises a number of systemic issues for Congressional consideration to better protect the public interest. It is fair to say that other business failures or restatements of financial statements have also sent signals that all is not well with the current system of financial reporting and auditing. As the largest corporation failure in U.S. history, Enron, however, provides a loud alarm that the current system may be broken and in need of an overhaul.

I will focus on four overarching areas—corporate governance, the independent audit of financial statements, oversight of the accounting profession, and accounting and financial reporting issues—where the Enron failure has already demonstrated that serious, deeply rooted problems may exist. It should be recognized that these areas are the keystones to protecting the public's interest and are interrelated. Failure in any of these areas places a strain on the entire system. The overall focus of these areas should be guided by the fundamental principles of having the right incentives for the key parties to do the right thing, adequate transparency to provide reasonable assurance that the right thing will be done, and full accountability if the right thing is not done. These three overarching principles represent a system of controls that should operate with a policy of placing special attention on those areas of greatest risk. In addition, an established code of ethics should set the "tone at the top" for expected ethical behavior in performance of all key responsibilities. The 1980's savings and loan crisis, for which this Committee was instrumental in shaping the reforms to protect deposit insurance and the public interest, is a prime example of the serious consequences that can result when one or more components of an interrelated system breaks down.

My comments today are intended to frame the broad accountability issues and provide our views on some of the questions and options that must be addressed to better safeguard the public interest going forward. There will no doubt be many views on what needs to be fixed and how to do it. We look forward to working with the Congress to provide assistance in defining the issues, exploring various options, and identifying their pros and cons in order to repair any weaknesses that threaten confidence in our capital markets and that inhibit improvements in the current system and appropriate actions by the key players. In considering changes to the current system that gave rise to Enron and other earlier financial reporting failures, it will be important that the Congress consider a holistic approach to addressing the range of interrelated issues. From all that has been heard from the inquiries to date, it is clear that there is no single silver bullet to fix the problems. It is also

clear that many parties are focusing on various elements of the issues but do not seem to be taking a comprehensive approach to addressing the many interrelated issues. This is what we are trying to do for the Congress.

On February 25, 2002, GAO held a forum on various governance, transparency, and accountability issues that was attended by experts in each of these areas. A summary of the results of the forum is being released today and is available at our website.[1] Also, we have completed the study of the SEC's resources that you requested and the report is being released today.[2] I will discuss the results of that work today as well.

Before discussing these matters, I would like to quickly provide an overview of the current corporate governance system, the independent audit function, regulatory oversight, and the accounting and financial reporting framework. An attachment to my prepared testimony graphically illustrates the interrelation and the complexity of these systems.

Overview of the Current Governance, Auditing, Oversight Systems, and Financial Reporting

Public and investor confidence in the fairness of financial reporting is critical to the effective functioning of our capital markets. The SEC, established in the 1930's following the stock market crash of 1929 and the Great Depression, protects investors by administering and enforcing Federal securities laws, and its involvement with requirements for financial disclosures and audits of financial statements for publicly-traded companies. In this respect, the public accounting profession, through its independent audit function, has received a franchise to audit and attest to the fair presentation of financial statements of publicly-traded companies. However, such a franchise brings with it not only the important role of attesting to the reliability of financial statements and related data, but also the concomitant responsibility of protecting the public interest and ensuring the public confidence through appropriate independence, professional competence, and high ethical standards for auditors.

The SEC, the primary Federal agency involved in accounting and auditing requirements for publicly-traded companies, has traditionally relied on the private sector for setting standards for financial reporting and independent audits, retaining a largely oversight role. Accordingly, the SEC has accepted the rules set by the Financial Accounting Standards Board (FASB)[3]—Generally Accepted Accounting Principles (GAAP)—as the primary standard for preparation of financial statements in the private sector. The SEC has accepted rules set by the American Institute of Certified Public Accountants' (AICPA) Auditing Standards Board—Generally Accepted Auditing Standards (GAAS)—as the standard for conducting independent audits of financial statements for private sector entities. The SEC monitors the performance of the standard setting bodies and also monitors the accounting profession's system of peer review, which checks compliance with applicable professional standards.

The SEC also oversees the activities of a variety of key market participants. It does this using the principle of self-regulation. According to this principle, the industry regulates itself through various self-regulatory organizations (SRO's) overseen by the SEC. SRO's are groups of industry professionals with quasi-governmental powers to adopt and enforce standards of conduct for their members. They include the nine securities exchanges, such as the New York Stock Exchange (NYSE) which regulate their marketplaces and the National Association of Securities Dealers (NASD) which regulates the over-the-counter market. In addition to regulating member broker-dealers, the SRO's establish listing standards for those firms that list on their market.

The AICPA administers a self-regulatory system for the accounting profession that includes setting auditing and independence standards, monitoring compliance, and disciplining members for violations of ethic rules and standards. The Public Oversight Board, administratively created by the AICPA in consultation with the SEC in 1977, monitors the public accounting firms' compliance with professional standards and oversees the Auditing Standards Board. State boards of accountancy license public accounting firms and individuals to practice public accounting within each State's jurisdiction.

[1] *Highlights of GAO's Forum on Corporate Governance, Transparency, and Accountability* (GAO–02–494SP, March 5, 2002).

[2] *SEC Operations: Increased Workload Creates Challenges* (GAO–02–302, March 5, 2002).

[3] FASB, as part of the Financial Accounting Foundation (FAF), is a not-for-profit organization supported by contributions from accounting firms, corporations, and the other entities that are interested in accounting issues. FASB consists of seven full-time members who are selected and approved by the FAF.

The audit is a critical element of the financial reporting structure because it subjects information in the financial statements to independent and objective scrutiny, increasing the reliability and assurance that can be placed on those financial statements for efficient allocation of resources in a capital market where investors are dependent on timely and reliable information. Management of a public company is responsible for the preparation and content of the financial statements, which are intended to disclose information that accurately depicts the financial condition and results of company activities. In addition, public companies registered with the SEC must maintain an adequate system of internal accounting control. The independent auditor is responsible for auditing the financial statements in accordance with generally accepted auditing standards to provide reasonable assurance that the financial statements are fairly presented in accordance with GAAP. The auditor's opinion on the financial statements is like an expert's stamp of approval to the public and the capital markets.

United States stock exchanges require listed companies to meet certain corporate governance standards, including that boards of directors have independent audit committees to oversee the accounting and financial controls of a company and the financial reporting process. Audit committees can help protect shareholder interests by providing sound leadership and oversight of the financial reporting process by working with management and both internal and external auditors.

The interrelation and complexity of the systems of corporate governance, auditing, oversight, and accounting and financial reporting, which cumulatively are the foundation for maintaining investor confidence in our capital markets, is graphically illustrated in the charts attached to this statement. The many links within and between the systems further illustrate the strain that can be placed on the overall system when weaknesses occur within any part of the system.

I would now like to focus on each of the four overarching areas that I mentioned earlier, starting with corporate governance.

Corporate Governance

I want to acknowledge immediately that serving on the Board of Directors of a public corporation is an important, difficult, and challenging responsibility. That responsibility is especially challenging in the current environment with increased globalization and rapidly evolving technologies having to be addressed while at the same time meeting quarterly earnings projections in order to maintain or raise the market value of the corporation's stock. These pressures, and the related executive compensation arrangements, unfortunately often translate to a focus on short-term business results. This can create the perverse incentives, such as managing earnings to inappropriately report favorable financial results, and/or failing to provide adequate transparency in financial reporting that disguises risks, uncertainties, and/or commitments of the reporting entity.

On balance though, the difficulty of serving on a public corporation's board of directors is not a valid reason for not doing the job right, which means being knowledgeable of the corporation's business, asking the right questions, and doing the right thing to protect the shareholders and the public interest. A board member needs to have a clear understanding of who is the client being served. Namely, their client should be the shareholders of the company, and all their actions should be geared accordingly. Audit committees have a particularly important role to play in assuring fair presentation and appropriate accountability in connection with financial reporting, internal control, compliance, and related matters.

Enron's failure has raised many questions about how its Board of Directors and audit committee were performing their duties and responsibilities. These questions include the following:

- Did the board of directors fulfill its fiduciary responsibility to shareholders and protect the public interest in overseeing Enron's management?
- Did the board operate in a proactive manner and raise the appropriate questions designed to identify key problems and mitigate related risks?
- Did the board have the appropriate industry, financial, or other appropriate expertise?
- Did board members have personal or business relationships that may have either in fact or in appearance affected their independence?
- Did the board, especially its audit committee, have an active interface and appropriate working relationship with Enron's internal and external auditors?
- Did the board and its audit committee have appropriate resources to do the job including staff and independent advisors?
- Did the board and its audit committee report meaningfully on their activities?

These are fundamental questions that as I previously mentioned are being addressed by various investigations and, therefore, I will not comment on those issues. However, these issues are instructive and, as a minimum, call for a review of the applicable rules and regulations that govern boards of directors. In that respect, the Administration recently formed a group of top financial policymakers and regulators to consider corporate governance and disclosure reforms. The SEC has asked the NYSE and Nasdaq to review corporate governance and listing standards, of public companies, including the important issues of officer and director qualifications and the formal codes of conduct. The SEC Chairman recently announced that the NYSE has established a Special Committee on Corporate Accountability and Listing Standards to examine corporate governance issues, including the possibility of requiring continuing education programs for officers and directors, and the Nasdaq also is taking similar steps. The corporate chief executives who make up the Business Roundtable have stated that they are reviewing their voluntary standards for corporate governance. The AFL–CIO has petitioned the SEC to amend its proxy disclosure requirements regarding conflicts of interest reportable by Board members. The California Public Employees' Retirement System (CalPERS) is also reviewing definitions and standards for independent corporate directors.

These examples are not intended to be a complete listing of reviews underway on corporate governance requirements. We applaud these initiatives. Hopefully, they will provide the opportunity for a thorough review of corporate governance requirements. These efforts will help to identify and frame the issues and to serve as a basis for determining whether the fundamental underpinnings for effective performance of boards of directors and audit committees are in place along with controls to monitor performance. Some basic factors to consider in reviewing the various requirements that govern membership and responsibilities of boards of directors of public companies include the following:

- Is there a clear understanding of whom the board is serving and its fiduciary responsibility to shareholders and related impact on the capital markets?
- What type of relationship should the board have with management (for example, constructive engagement)?
- What, if any, selection process changes are necessary in order to assure the proper identification of qualified and independent board members?
- Is the nominating process for board membership designed to ensure that the board is getting the right mix of talent to do the job?
- Do board membership rules address who other than management would nominate board members?
- Are the independence rules for outside directors and audit committee members sufficient to ensure the objectivity of the members?
- Do board membership rules address whether the corporation's CEO should be allowed to be the board chairman?
- Do board membership rules address whether independent board members should nominate the chairman of the board?
- Do board membership rules address whether members of corporation management, including the CEO, should be allowed to be board members, and if so, what percentage of total board membership?
- Do board membership rules address whether corporation service providers, such as the major customers or other related parties, should be allowed to be board members?
- Do requirements ensure that the board will have access to the resources and staff necessary to do the job, including its own staff and access to independent legal counsel and other experts?
- Do requirements ensure that the responsibilities of board members, including the members who serve on audit committees and other committees, such as the nominating, finance, and compensation committees, are required to be committed to a charter that governs their operation?
- Do requirements address the appropriate working relationship between the audit committee and the internal and external auditors?
- Do requirements provide for the board of directors to establish a formal code of conduct to set the tone for expected personal and business ethical behavior within the corporation?
- Do requirements provide that waivers of the code of conduct are not expected and should such circumstances arise, which should be extremely rare, that any exceptions must be approved by the board of directors and publicly reported?

- Do requirements provide for public reporting on the effectiveness of internal control by management and independent assurances on the effectiveness of internal control by the corporation's independent auditors?
- Do requirements provide for public reporting by the board of directors, the audit committee, and other committees of the board on their membership, responsibilities, and activities to fulfill those responsibilities?
- Do the stock exchanges and the SEC have sufficient authority to enforce requirements governing boards of directors and audit committees and to take meaningful enforcement actions, including imposing effective sanctions when requirements are violated?
- Does the SEC have sufficient resources and authority to fulfill its responsibilities under the Federal securities laws and regulations to operate proactively in monitoring SEC's registrants for compliance and to take timely and effective actions when noncompliance may exist?
- Is the SEC efficiently and effectively using technology to manage its regulatory responsibilities under the Federal securities laws by assessing risks, screening financial reports and other required filings, and accordingly prioritizing the use of its available resources?

Boards of directors and their audit committees are a critical link to fair and reliable financial reporting. A weak board of directors will also likely translate into an ineffective audit committee. That combination makes the difficult job of auditing the financial statements of large corporations, which usually have vast, complex, and diversified operations, much more challenging.

Regulation and Oversight of the Accounting Profession

The model for regulation and oversight of the accounting profession involves Federal and State regulators and a complex system of self-regulation by the accounting profession. The functions of the model are interrelated and their effectiveness is ultimately dependent upon each component working well. Basically, the model includes the functions of:

- Licensing members of the accounting profession to practice within the jurisdiction of a State, as well as issuing rules and regulations governing member conduct, which is done by the State boards of accountancy.
- Setting accounting and auditing standards, which is done by the Financial Accounting Standards Board and the Auditing Standards Board, respectively, through acceptance of the standards by the SEC.
- Setting auditor independence rules, which within their various areas of responsibility, have been issued by the AIPCA, the SEC, and GAO.
- Oversight and discipline, which is done through systems of self-regulation by the accounting profession and the public regulators (the SEC and the State boards of accountancy).

The Enron failure has brought a direct focus on how well the systems of regulation and oversight of the accounting profession are working in achieving their ultimate objective that the opinions of independent auditors on the fair presentation of financial statements can be relied upon by the investors, the creditors, and the various other users of financial reports.

The issues currently being raised about the effectiveness of the accounting profession's self-regulatory system are not unique to the collapse of Enron. Other business failures or restatements of financial statements over the past several years have called into question the effectiveness of the system. A continuing message is that the current self-regulatory system is fragmented, is not well-coordinated, and has a discipline function that is not timely nor does it contain effective sanctions, all of which create a public image of ineffectiveness. Reviews of the system should consider whether overall the system creates the right incentives, transparency, and accountability, and operates proactively to protect the public interest. Also, the links within the self-regulatory system and with the SEC and the State boards of accountancy (the public regulatory systems) should be considered as these systems are interrelated and weaknesses in one component can put strain on the other components of the overall system.

I would now like to address some of the more specific areas of the accounting profession's self-regulatory system that should be considered in forming and evaluating proposals to reshape or overhaul the current system.

Accounting Profession's Self-Regulatory System

The accounting profession's current self-regulatory system is largely operated by the AICPA through a system, largely composed of volunteers from the accounting

profession. This system is used to set auditing standards and auditor independence rules, monitor member public accounting firms for compliance with professional standards, and discipline members who violate auditing standards or independence rules. AICPA staff support the volunteers in conducting their responsibilities. The Public Oversight Board oversees the peer review system established to monitor member public accounting firms for compliance with professional standards. In 2001, the oversight authority of the Public Oversight Board was expanded to include oversight of the Auditing Standards Board. The Public Oversight Board has five public members and professional staff, and receives its funding from the AICPA.

On January 17, 2002, the SEC Chairman outlined a proposed new self-regulatory structure to oversee the accounting profession. On January 20, 2002, the Public Oversight Board passed a resolution of intent to terminate its existence no later than March 31, 2002. The Public Oversight Board's Chairman was critical of the SEC's proposal and expressed concern that the Board was not consulted about the proposal. The SEC's proposal provided for creating an oversight body that would include monitoring and discipline functions, have a majority of public members, and be funded through private sources. No further details have been announced.

The authority for the oversight body is a basic but critical factor that can influence its operating philosophy, its independence, and, ultimately, its effectiveness. Related factors to consider include:

- Determining whether the body should be created by statute or administratively, such as is the case for the current Public Oversight Board.
- Deciding the basic scope of the body's enabling authority, such as whether oversight authority should be limited to coverage of the public accounting firms that audit SEC registrants, which is the authority of the current Public Oversight Board, or whether it should be expanded to other public accounting firms that also provide audit services to a broader range of entities.
- Determining mission objectives clearly to ensure that protecting the public interest is paramount.

Membership of the oversight body and its funding may also influence the body's operating philosophy (proactive as opposed to reactive), independence, and resolve to actively assess and minimize risks within the system that affect protecting the public interest. Factors to consider include:

- Whether the membership should be limited to public members (exclude practicing members of the accounting profession), such as is the case for current Public Oversight Board.
- Whether membership should allow some practicing members of the accounting profession to sit on the board.
- How the members will be selected, including the chairman, their term limits, and compensation.
- How the amount and source of funding will be established since a problem with either may present potential conflicts or limit the oversight body's ability to effectively protect the public interest.

The responsibilities of the oversight body and its powers to perform those responsibilities will largely define whether the oversight body is set up with a sufficient span of responsibility to oversee the activities of the accounting profession and to take appropriate actions when problems are identified. Related factors to consider include:

- Whether the current system of peer review should be continued in its present form and monitored by the oversight body, such as was done by the Public Oversight Board, with oversight by the SEC.
- Whether the oversight body should have more control over the peer review function, such as selecting and hiring peer reviewers, managing the peer review, and being the client for the peer review report.
- Whether the oversight body's authority should extend to all standard setting bodies within the accounting profession so that accounting, auditing, quality control and assurance, and independence standards are subject to oversight (currently the Public Oversight Board does not oversee the setting of accounting standards or auditor independence rules).
- Whether the oversight body's authority related to standard setting should be expanded to direct standard setting bodies to address any problems with standards and approve the adequacy of revised standards (currently the Public Oversight Board does not have such direct authority).
- Whether the oversight body's authority should extend to the discipline function (currently the Public Oversight Board does not oversee the discipline function).

- Whether the oversight body should have investigative authority over disciplinary matters (currently this function is housed within another component of the AICPA) or authority to request investigations.
- Whether the body within the self-regulatory system responsible for investigations of disciplinary matters should have power to protect investigative files from discovery during litigation to facilitate cooperation and timeliness in resolving cases.

Accountability requirements can provide for stewardship of resources, help to set the operating philosophy of the oversight body, and provide a means of monitoring the oversight body's performance. The current Public Oversight Board, POB, issues an annual report and its financial statements are audited. Related factors to consider include:

- Whether the oversight body should prepare strategic and annual performance plans.
- Whether the oversight body should have an annual public reporting requirement and what information should be included in the report, such as whether the report should be limited to the oversight body's activities or whether the report should provide more comprehensive information about the activities of the entire self-regulatory system, and whether the oversight body should have audited financial statements.
- Whether and, if so, how Congress should exercise periodic oversight of the performance of the self-regulatory system and the performance of the oversight body.

At this time, the outcome of the SEC's proposal to establish a body for overseeing the accounting profession that would include monitoring and discipline functions is uncertain. There is considerable overlap in the functions of the current self-regulatory system and the functions of the SEC related to the accounting profession. For example, the AICPA sets auditor independence rules applicable to its membership, and the SEC sets auditor independence rules for those auditors who audit the SEC's registrants. Also the AICPA disciplines its members for noncompliance with independence rules or auditing standards. The SEC, through its enforcement actions, disciplines auditors of SEC registrants who violate its laws and regulations, which include noncompliance with independence rules and auditing standards. In addition, the SEC also conducts various activities to oversee the peer review function of the self-regulatory system.

As proposals are considered for reshaping or for overhauling the self-regulatory system, the overlap of functions with the SEC's responsibilities should be considered to provide for oversight of the accounting profession that is both efficient and effective. Related factors to consider include the following:

- Whether current independence rules are adequate to protect the public interest.
- Whether independence rules for auditors should be consistent and set by the Government or private sector, or whether the status quo is acceptable.
- Whether the current system of peer review is acceptable or whether the SEC should play a role that exercises more direct control or oversight of the accounting profession's compliance with standards.
- How the investigative/enforcement functions of the self-regulatory system and the SEC can be jointly used to efficiently and to effectively achieve their common objectives to resolve allegations of audit failure.

Similarly, the discipline functions of the SEC and the self-regulatory system overlap with the State boards of accountancy, which are the only authorities that can issue or revoke a license to practice within their jurisdictions. The communication and working relationship opportunities for efficiency and effectiveness that exist between the SEC and the self-regulatory system also exist for their relationship with the State boards of accountancy in resolving allegations of audit failure.

The Independent Audit Function

For over 70 years, the public accounting profession, through its independent audit function, has played a critical role in enhancing a financial reporting process that facilitates the effective functioning of our domestic capital markets, as well as international markets. The public confidence in the reliability of issuers' financial statements that is provided by the performance of independent audits encourages investment in securities issued by public companies. This sense of confidence depends on reasonable investors perceiving auditors as independent expert professionals who have neither mutual nor conflicts of interests in connection with the entities they are auditing. Accordingly, investors and other users expect auditors to bring to the financial reporting process integrity, independence, objectivity, and technical competence, and to prevent the issuance of misleading financial statements.

The Enron failure has raised questions concerning whether auditors are living up to the expectations of the investing public; however, similar questions have been repeatedly raised over the past three decades by significant restatements of financial statements and unexpected costly business failures. Issues debated over the years continue to focus on the auditor independence concerns and the auditor's role and responsibilities, particularly in detecting and reporting fraud and assessing the effectiveness of and reporting on internal control.

Auditor Independence Concerns

The independence of public accountants—both in fact and in appearance—is very crucial to the credibility of financial reporting and, in turn, the capital formation process. Auditor independence standards require that the audit organization and the auditor be independent in fact and in appearance. These standards place responsibility on the auditor and the audit organization to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as being impartial by knowledgeable third parties.

Since the mid-1970's, many observers of the auditing profession have expressed concern about the expanding scope of professional services provided by the public accounting profession. Specifically, questions have been raised by the media, the Congress, and others concerning the propriety of performing both audit and certain nonaudit services for the same client. While these services and their perceived impact on accounting firms' independence have been the subject of many studies and while actions have been taken to strengthen auditor independence, the Enron failure has brought this issue once again to the forefront and has sparked new proposals to prohibit or limit auditors from providing nonaudit services to audit clients. A common concern is that when auditor fees for consulting services are a substantial part of total auditor fees, this situation can create pressures to keep the client happy and can threaten auditor independence.

Auditors have the capability of performing a range of valuable services for their clients, and providing certain nonaudit services can ultimately be beneficial to investors and other interested parties. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, the client, or both will have to make a choice as to which of these services the auditor will provide. These concepts, which I strongly believe are in the public interest, are reflected in the revisions to auditor independence requirements for Government audits,[4] which GAO recently issued as part of *Government Auditing Standards.*[5] The new independence standard has gone through an extensive deliberative process over several years, including extensive public comments and input from my Advisory Council on Government Auditing Standards.[6] The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The two overarching principles in the standard for nonaudit services are that:

- The auditors should not perform management functions or make management decisions.
- The auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

Both of the above principles should be applied using a substance over form determination. Under the revised standard, auditors are allowed to perform certain nonaudit services provided the services do not violate the above principles; however, in most circumstances certain additional safeguards would have to be met. For example: (1) personnel who perform allowable nonaudit services would be precluded from performing any related audit work, (2) the auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work were performed by another unrelated party; and (3) certain documentation and quality assurance requirements must be met. The new standard includes an express prohibition regard-

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[4] *Government Auditing Standards, Amendment No. 3, Independence* (GAO/A–GAGAS–3, January 2002).

[5] *Government Auditing Standards* were first published in 1972 and are commonly referred to as the "Yellow Book," and cover Federal entities and those organizations receiving Federal funds. Various laws require compliance with the standards in connection with audits of Federal entities and funds. Furthermore, many States and local governments and other entities, both domestically and internationally, have voluntarily adopted these standards.

[6] The Advisory Council includes 20 experts in financial and performance auditing and reporting drawn from all levels of Government, academia, private enterprise, and public accounting, who advise the Comptroller General on *Government Auditing Standards.*

ing auditors providing certain bookkeeping or recordkeeping services and limits payroll processing and certain other services, all of which are presently permitted under current independence rules of the AICPA.

The focus of these changes to the *Government Auditing Standards* is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of Government entities and entities that receive Federal funding. However, these standards apply only to audits of Federal entities and those organizations receiving Federal funds, and not to audits of public companies. In the transmittal letter issuing the new independence standard, we expressed our hope that the AICPA will raise its independence standards to those contained in this new standard in order to eliminate any inconsistency between this standard and their current standards. The AICPA's recent statement before another Congressional committee that the AICPA will not oppose prohibitions on auditors providing certain nonaudit services seems to be a step in the right direction.[7] In 2000, the SEC considered a principle-based approach for auditor independence rules applicable to auditors of the SEC's registrants, but decided in the end to set specific rules by types of nonaudit services. We believe a principle-based approach is more effective given the wide variety of nonaudit services provided by auditors and the continuing evolution of the market.

The new independence standard is the first of several steps GAO has planned in connection with nonaudit services covered by *Government Auditing Standards.* In May 2002, we plan to issue a question and answer document concerning our independence standard, and I will ask my Advisory Council on Government Auditing Standards to review and monitor this area to determine what, if any, additional steps may be appropriate. In addition, the Principals of the Joint Financial Management Improvement Program, who are the Comptroller General, the Secretary of the Treasury, and the Director of the Office of Management and Budget, have agreed that the 24 major Federal departments and agencies covered by the Chief Financial Officers Act should have audit committees. The scope, structure, and timing of this new requirement will be determined over the next several months. This will include determining what role these audit committees might play in connection with nonaudit services.

Another auditor independence issue, which also existed with Enron, concerns the employment by the client of its former auditor. The revolving door between auditors and the companies they audit has existed for years. This is due in part to the mandatory retirement of partners from public accounting firms, often before the partners are ready to leave the profession. Another contributing factor that entices auditors to work for audit clients is the lucrative compensation for executives in public companies. Employment by the client of its former auditor can have a clear implication on the quality of audits and has been cited as a factor in the savings and loan scandal of the late 1980's. The AICPA asked the SEC in 1993 to prohibit public companies from hiring their audit partner for a year after an audit. The SEC rejected the proposal as too difficult to enforce. However, Enron has resurfaced the issue. One Congressional proposal would prohibit an accounting firm from providing audit services to a company whose controller or chief financial officer had worked for that public accounting firm. This issue again raises the auditor independence perception problem and provides another opportunity to further enhance auditor independence. A factor to consider in this debate includes mandating a "cooling off period" in which a partner or senior auditor from a firm cannot go to work for a former audit client for a period of time after separating from their firm.

A related issue is whether an audit firm should be allowed to serve as the client's auditor of record without a limit on the period of time. Currently, there are no time limits for rotation of audit firms, although the AICPA requirements for member firms that audit SEC registrants require partner rotation every 7 years. The concerns are that the auditor may become too close to management over a period of years and, therefore, threaten the auditor's objectivity. Also the auditor's familiarity with the business operations of the client may result in a less than thorough audit. Opposing arguments against auditor rotation include that there is a significant learning curve for a new auditor and, during that time, there is a greater risk of the auditor overlooking transactions that may result in misleading financial statements. Also, auditor rotations can increase audit costs for the client.[8] Building on

[7] Testimony of AICPA Chairman before the House Energy and Commerce Committee (Subcommittee on Communications, Trade and Consumer Protection), February 14, 2002.

[8] Federal, State, and local government auditors generally have their responsibilities defined by law or regulation. Therefore, rotation of Government auditors raises different considerations than in the private sector. However, the rationale behind rotation of auditors (enhancing auditor

Continued

the current AICPA requirement for rotating the audit engagement partner every 7 years, rotating additional key members of the audit team is another alternative to consider. Rotating additional key members of the audit team should have less of an impact of the auditor's learning curve and not increase audit costs, although this option would still leave open the appearance of an independence issue for the firm.

Study groups over the years have recognized that corporate boards and their audit committees could and should play a more significant role in strengthening the independence of audits. The situation with Enron and its auditors is another event that highlights the necessity to reexamine relationships of boards of directors, audit committees, and management with the independent auditor in order to strengthen the objectivity and professionalism of the independent auditor and to enhance the independent audit. Factors to consider in making changes include the following:

- Who should be the client for the audit?
- Should the audit committee be actively responsible for hiring, determining fees, and terminating the auditor?
- Should there be more required communication and interaction between the auditor and the audit committee?
- Should the audit committee preapprove the provision of certain nonaudit services by audit firms?
- Should the audit committee be required to review and to approve the staffing of audit firm personnel?

Auditor's Roles and Responsibilities for Fraud and Internal Control

Under current auditing standards, auditors are responsible for planning and performing the audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error, illegal acts, or fraud. As stated over the years by many who have studied the profession, no major aspect of the independent auditor's role has caused more difficulty than the auditor's responsibility for detecting fraud. In August 2000, the Panel on Audit Effectiveness concluded that the auditing profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management.[9] The study expressed concern that auditors may not be requiring enough evidence, that is, they have reduced the scope of their audits and level of testing, to achieve reasonable assurance about the reliability of financial information that the capital markets need for their proper functioning. The study recommended that auditing standards be strengthened to effect a substantial change in auditors' performance and thereby improve the likelihood that auditors will detect fraudulent financial reporting. The AICPA is working on a new auditing standard to improve auditor performance in this area, which it expects to issue by the end of this year.

We have long believed that expanding auditors' responsibilities to report on the effectiveness of internal control over financial reporting would assist auditors in assessing risks for the opportunity of fraudulent financial reporting or misappropriation of business assets. Currently, the auditor's report on a public company's financial statements does not address internal control or purport to give any assurance about it, and auditors are not required to assess the overall effectiveness of internal control or search for control deficiencies. The important issues of the auditor's responsibility for detecting and reporting fraud and for reporting on internal control overlap since effective internal control is the major line of defense in preventing and detecting fraud. Taken together, these issues raise the broader question of determining the proper scope of the auditor's work in auditing financial statements of publicly-owned companies. The auditor would be more successful in preventing and detecting fraud if auditors were required to accept more responsibility for reporting on the effectiveness of internal control. The Congress recognized the link between past failures of financial institutions and weak internal control when it enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 that grew out of the savings and loan crisis. The Act requires an independent public auditor to report on the effectiveness of internal control for large financial institutions.

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independence) is addressed in *Government Auditing Standards.* The standards add organizational criteria that consider factors in the appointment, removal, and reporting responsibilities of the head of the audit organization to ensure independence. The organizational criteria for determining auditor independence are in addition to personal and external requirements that are considered in judging the independence of Government auditors.

[9] *The Panel on Audit Effectiveness Report and Recommendations* (August 31, 2000). The Panel was formed by the Public Oversight Board at the request of the SEC to study the effectiveness of the audit model and other issues affecting the accounting profession.

And for all of the financial statements audits that we conduct, which include the consolidated financial statements of the Federal Government, and the financial statements of the Internal Revenue Service, the Bureau of Public Debt, the Federal Deposit Insurance Corporation, and the numerous smaller entities' operations and funds, we issue separate opinions on the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations. We require extensive testing of controls and of compliance in our audits. We have done this for many years because of the importance of internal control to protecting the public interest. Our reports have engendered major improvements in internal control. And as you might expect, as part of the annual audit of our own financial statements, we practice what we recommend to others and contract with a CPA firm for both an opinion on our financial statements and an opinion on the effectiveness of our internal control over financial reporting and compliance with applicable laws and regulations. We believe strongly that the AICPA should follow suit and work with the SEC to require expanded auditor involvement with internal control of public companies.

The AICPA Chairman recently expressed the accounting profession's support for auditor reporting on the effectiveness of internal control.[10] Auditors can better serve their business clients and other financial statements users and protect the public interest by having a greater role in providing assurances of the effectiveness of internal control in deterring fraudulent financial reporting, protecting assets, and providing an early warning of internal control weaknesses that could lead to business failures. The SEC, the AICPA, and the corporate boards of directors are major stakeholders in achieving realistic auditing standards for fraud and internal control. However, as we stated in our 1996 report on the accounting profession,[11] the SEC is the key player in providing the leadership and in bringing these parties together to enhance auditor reporting requirements on the effectiveness of internal control. We believe it would be difficult for the AICPA to unilaterally expand audit requirements without SEC support.

Accounting and Financial Reporting Model

Business financial reporting is critical in promoting an effective allocation of capital among companies. Financial statements, which are at the center of present-day business reporting, must be relevant and reliable to be useful for decisionmaking. In our 1996 report on the accounting profession,[12] we reported that the current financial reporting model does not fully meet users' needs.

We found that despite the continuing efforts of standard setters and the SEC to enhance financial reporting, changes in the business environment, such as the growth in information technology, new types of relationships between companies, and the increasing use of complex business transactions and financial instruments, constantly threaten the relevance of financial statements and pose a formidable challenge for standard setters. A basic limitation of the model is that financial statements present the business entity's financial position and results of its operations largely on the basis of historical costs, which do not fully meet the broad range of user needs for financial information.[13]

In 1994, the AICPA's Special Committee on Financial Reporting, after studying the concerns over the relevance and usefulness of financial reporting and the information needs of professional investors and creditors, concluded that the current model is useful as a reliable information basis for analysts, but concluded that a more comprehensive model is needed that includes both financial information and nonfinancial information. In addition to financial statements and related disclosures, the model recommended by the study would include:

- High-level operating data and performance measures that management uses to manage the business.
- Management's analysis of changes in financial and nonfinancial data.

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[10] See footnote 7.

[11] *The Accounting Profession Major Issues: Progress and Concerns* (GAO/AIMD–96–98, September 24, 1996).

[12] See footnote 11.

[13] The accounting and reporting model under Generally Accepted Accounting Principles is actually a mixed-attribute model. Although most transactions and balances are measured on the basis of historical cost, which is the amount of cash or its equivalent originally paid to acquire an asset, certain assets and liabilities are reported at current values either in the financial statements or related notes. For example, certain investments in debt and equity securities are currently reported at fair value, receivables are reported at net realizable value, and inventories are reported at the lower of cost or market value. Further, certain industries such as brokerage houses and mutual funds prepare financial statements on a fair value basis.

- Forward-looking information about opportunities, risks, and management's plans, including discussions about critical success factors, as well as information about management and shareholders.
- Background about the company, including a description of the business, its industry, and its objectives and strategies.

The Committee acknowledged that many business entities do report nonfinancial information, but it stressed the need to develop a comprehensive reporting package that would promote consistent reporting and the need to have auditors involved in providing some level of assurance for each of the model's elements. Opposing views generally cite liability concerns as a risk to reporting forward-looking and other related nonfinancial information, concerns over the cost of preparing the information, and concerns whether more specific disclosures would put business entities at a competitive disadvantage. Although standard setters have addressed certain issues to improve the financial reporting model, a project to develop a more comprehensive reporting model has not been undertaken.

Enron's failure and the inquiries that have followed have raised many of the same issues about the adequacy of the financial reporting model, such as the need for transparency, clarity, and risk-oriented financial reporting, addressed by the AICPA's Special Committee on Financial Reporting. The limitations of the historical cost-based model were made more severe in the case of the Enron failure by accounting rules and reports designed for a pipeline operator that transitioned into a company using numerous offshore, off balance sheet, quasi-affiliated, tax shelter entities to operate, invest in, trade or make a market for contracts involving water, electricity, natural gas, and broadband capacity. However, criticism of the financial reporting model should also consider the criticisms of the corporate governance system, the auditing profession, and the regulatory and the self-regulatory oversight models which may impact the quality of financial reporting. Also, human failure to effectively perform responsibilities in any one or in all four of these areas has been raised by the many inquiries following Enron's sudden failure. In addition, Enron's November 8, 2001 reporting to the SEC (Form 8–K filing), which restated its financial statements for the years ended December 31, 1997 through 2002, and the quarters ended March 31 and June 30, 2001, acknowledges that the financial reports did not follow Generally Accepted Accounting Principles and, therefore, should not be relied upon.

Among other actions to address the Enron-specific accounting issues, the SEC has requested that the FASB address the specific accounting rules related to Enron's special purpose entities and to related party disclosures. Therefore, the SEC is expecting the FASB to revise and to finalize the special purpose accounting rules by the end of this year. The FASB has stated it is committed to proceed expeditiously to address any financial accounting and reporting issues that may arise as a result of Enron's bankruptcy. In that respect, the FASB at a recent board meeting set a goal of publishing an exposure draft by the end of April 2002 and a final statement by the end of August 2002 that would revise the accounting rules for special purpose entities. The SEC has also announced specific areas for improving disclosures, and they include:

- More current disclosure, including "real-time" disclosure of unquestionable material information.
- Disclosure of significant trend data and more "evaluative" data.
- Financial statements that are clearer and more informative for investors.
- Disclosure of the accounting principles that are most critical to the company's financial status and that involve complex or subjective decisions by management.
- Private-sector standards setting that is more responsive to the current and immediate needs of investors.

In addition, the SEC has announced plans to propose new corporate disclosure rules that will:

- Provide accelerated reporting by companies of transactions by company insiders in company securities, including transactions with the company.
- Accelerate filing by companies of their quarterly and annual reports.
- Expand the list of significant events requiring current disclosure on existing Form 8–K filings (such events could include changes in rating agency decisions, obligations that are not currently disclosed, and lock-out periods affecting certain employee plans with employer stock).
- Add a requirement that public companies post their Exchange Act reports on their websites at the same time they are filed with the SEC.

- Require disclosure of critical accounting policies in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in annual reports.

The SEC Chief Accountant has also raised concerns that the current standard setting process is too cumbersome and slow and that much of the FASB's guidance is rule-based and too complex. He believes that (1) principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues, (2) the FASB needs to be more responsive to accounting standards problems identified by the SEC, and (3) the SEC needs to give the FASB freedom to address the problems, but the SEC needs to monitor projects and, if they are languishing, determine why.

We support the SEC's stated plans to specifically address the accounting issues raised by the Enron failure and the broader-based planned initiatives that begin to address some of the overarching issues with the current financial reporting model. It will be important that these initiatives be aimed at the end result of having a financial reporting model that is more comprehensive while, at the same time, more understandable and timely in providing current value financial information and nonfinancial information that will provide users with data on the reporting entity's business risks, uncertainties, and outlook, including significant assumptions underlying the nonfinancial information. We also support a more direct partnering between the SEC and the FASB to facilitate a mutual understanding of priorities for standard setting and realistic goals for achieving expectations.

On balance, standard setting is inherently difficult and subject to pressures by those parties most affected by proposed changes. Today's business environment that includes increased globalization, rapid technological advances, real-time communication, and extremely sophisticated financial engineering is a difficult challenge for accounting standard setters as our commercial world moves from an industrial base to an information base. Further more, creative use of financial reports, such as the recent phenomenon of using "pro forma" financial statements to present a "rosier picture" than GAAP may otherwise allow, adds another challenge for standard setters and regulators. On December 4, 2001, the SEC issued FRR No. 59, *Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases.* One of the key points in the cautionary advice release was that the antifraud provisions of the Federal securities laws apply to a company issuing "pro forma" financial information.

With that said, we believe that the underlying principles of accounting and of financial reporting are still valid, namely, that financial reporting must reflect the economic substance of transactions, be consistently applied, and provide fair representation in accordance with Generally Accepted Accounting Principles. In applying these underlying principles, it is important to recognize the variety of users of financial information and their financial acumen. One size will not likely fit all, and targeted audiences for reported financial information may need to be identified, such as sophisticated investors, analysts, and creditors versus the general public. We also believe that the auditors need to be active players in developing a more comprehensive model with the objective of adding value to the information through independent assurances. Finally, effective corporate governance, independent auditors, and regulatory oversight must accompany accounting standards and financial reporting. For meaningful and reliable financial reporting, it is not enough to say the rules were followed, which is the minimum expectation. Those with responsibilities for financial reporting and their auditor must ensure that the economic substance of business transactions is, in fact, fairly reported.

I would now like to turn to the results of the work that you requested in asking us to look at the resource issues at the SEC.

The SEC's Ability to Fulfill Its Mission

Over the last decade, securities markets have experienced unprecedented growth and change. Moreover, technology has fundamentally changed the way that markets operate and how investors access markets. These changes have made the markets more complex. In addition, the markets have become more international, and legislative changes have resulted in a regulatory framework that requires increased coordination among financial regulators and requires that the SEC regulate a greater range of products. Moreover, as I discussed earlier, the recent, sudden collapse of Enron and the other corporate failures have stimulated an intense debate on the need for broadbased reform in such areas as financial reporting and accounting standards, oversight of the accounting profession, and corporate governance, all of which could have significant repercussions on the SEC's role and oversight challenges. At the same time, the SEC has been faced with an ever-increasing workload

and ongoing human capital challenges, most notably high staff turnover and numerous vacancies.

In our work requested by this Committee, for which our report is being released at this hearing, we found that the SEC's ability to fulfill its mission has become increasingly strained due in part to imbalances between the SEC's workload (such as filings, complaints, inquiries, investigations, examinations, and inspections) and staff resources.[14] Although industry officials complimented the SEC's regulation of the industry given its staff size and budget, both the SEC and industry officials identified several challenges that the SEC faces. First, resource constraints have contributed to substantial delays in the turnaround time for many SEC regulatory and oversight activities, such as approvals for rule filings and exemptive applications.[15] Second, resource constraints have contributed to bottlenecks in the examination and inspection area as the SEC's workload has grown. Third, limited resources have forced the SEC to be selective in its enforcement activities and have lengthened the time required to complete certain enforcement investigations.[16] Fourth, certain filings were subject to less frequent and less complete reviews as workloads increased. Fifth, today's technology-driven markets have created ongoing budgetary and staff challenges. Finally, the SEC and industry officials said that the SEC has been increasingly challenged in addressing emerging issues, such as the ongoing internationalization of securities markets and technology-driven innovations like Alternative Trading Systems[17] (ATS's), and exchange-traded funds.

The SEC routinely prioritizes and allocates resources to meet workload demands, but faces increasing pressure in managing its mounting workload and staffing imbalances that resulted from its workload growing much faster than its staff. Critical regulatory activities, such as reviewing rule filings and exemptive applications and issuing guidance, have suffered from delays due to limited staffing. According to industry officials, these delays have resulted in forgone revenue and have hampered market innovation. Oversight and supervisory functions have also been affected. For example, staffing limitations and increased workload have resulted in the SEC reviewing a smaller percentage of corporate filings, an important investor protection function. In 2001, the SEC reviewed about 16 percent of the annual corporate filings, or about half of its annual goal of 30 to 35 percent. Although the SEC is revamping its review process to make it more risk-based, recent financial disclosure and accounting scandals illustrate how important it is that the SEC rise to the challenge of providing effective market oversight to help maintain investor confidence in securities markets.

SEC Staff Turnover

In addition to the staff and workload imbalances, other factors also contribute to the challenges the SEC currently faces. SEC officials said that although additional resources could help the SEC do more, additional resources alone would not help the SEC address its high staff turnover, which continues to be a problem. Furthermore, in recent years the staff turnover and large differentials in pay between the SEC and other financial regulators and industry employers resulted in many staff positions remaining vacant as staff left at a faster rate than the SEC could hire new staff. Although the SEC now has the authority to provide pay parity, its success will depend upon the SEC's designing an effective implementation approach and the agency receiving sufficient budgetary resources. We found that the SEC's budget and strategic planning processes could be improved to better enable the SEC to determine the resources needed to fulfill its mission. For example, unlike recognized high performing organizations, the SEC has not systematically utilized its strategic planning process to ensure that (1) resources are best used to accomplish its basic statutorily mandated duties and (2) workforce development addresses the resource

[14] Staff resources are measured in this report in terms of full-time equivalent staff years.

[15] A company files an exemptive application when it seeks an SEC decision to exempt a new activity from existing rules and laws.

[16] The SEC Chairman has recently announced an initiative called real-time enforcement, which is intended to protect investors by (1) obtaining emergency relief in Federal court to stop illegal conduct expeditiously, (2) filing enforcement actions more quickly, thereby compelling disclosure of questionable conduct so that the public can make informed investment decisions, and (3) deterring future misconduct through imposing swift and stiff sanctions on those who commit egregious frauds, repeatedly abuse investor trust, or attempt to impede the SEC's investigatory processes. According to the SEC, insufficient resources may inhibit the effectiveness of this initiative, which depends upon prompt action by enforcement staff.

[17] An ATS is an entity that performs functions commonly performed by a stock exchange.

needs that are necessary to fulfill the full scope of its mission, including activities to address emerging issues.[18]

As we noted in our 2001 report on the SEC's human capital practices, about one-third of the SEC's staff left the agency from 1998 to 2000.[19] The SEC's turnover rate for attorneys, accountants, and examiners averaged 15 percent in 2000, more than twice the rate for comparable positions government-wide. Although the rate had decreased to 9 percent in 2001, turnover at the SEC was still almost twice as high as the rate government-wide. Further, as a result of this turnover and inability to hire qualified staff quickly enough, about 250 positions remained unfilled in September 2001, which represents about 8.5 percent of the SEC's authorized positions. SEC officials said that they could do more if they had more staff, but all cited the SEC's high turnover rate as a major challenge in managing its workload. Likewise industry officials agreed that many of the challenges that the SEC faces today are exacerbated by its high turnover rate, which results in more inexperienced staff and slower, often less efficient, regulatory processes.

Although the SEC and industry officials said that the SEC would always have a certain amount of turnover because staff can significantly increase their salaries in the private sector and some staff only plan to stay at the SEC for a period of time, many said pay parity with other financial regulators could enable the SEC to attract and retain staff for a few additional years. The SEC estimated that a new employee generally takes about 2 years to become fully productive and that pay parity could help them keep staff a year or two beyond the initial 2 years. Although industry officials said they were generally impressed by the caliber of staff that the SEC hires and the amount of work they do, they said that staff inexperience often requires senior SEC officials to become more involved in basic activities. Industry officials also said that certain divisions, such as Market Regulation, could benefit from staff with a fundamental understanding of how markets work and market experience. They said that such experience could help speed rulemaking and review processes. However, SEC officials said that they have a difficult time attracting staff with market experience, given the Government's pay structure.

Some officials said that the SEC's turnover rate should decrease after pay parity is implemented? Presently, the SEC professional staff are paid according to Federal general pay rates. On January 16, 2002, the President signed legislation that exempted the SEC from Federal pay restrictions and provided it with the authority necessary to bring salaries in line with those of other Federal financial regulators. That legislation also mandated that we conduct a study to look at the feasibility of the SEC becoming a fully self-funded agency. Although the SEC now has the authority to implement pay parity, as of March 1, 2002, the SEC has not received an additional appropriation to fund its implementation. In addition, the SEC has to take a number of steps to effectively implement this new authority.

Although the SEC's workload and staffing imbalances have challenged the SEC's ability to protect investors and maintain the integrity of securities markets, the SEC has generally managed the gap between workload and staff by determining what basic statutorily mandated duties it could accomplish with existing resource levels. This approach, while practical, under the circumstances, has forced the SEC's activities to be largely reactive rather than proactive. For instance, the SEC has not put mechanisms in place to identify what it must do to address emerging and evolving issues. Although the SEC has a strategic plan and has periodically adjusted staffing or program priorities to fulfill basic obligations, the SEC has not engaged in a much needed, systematic reevaluation of its programs and activities in light of current and emerging challenges. Given the regulatory pressures facing the SEC and its ongoing human capital challenges, it is clear that the SEC could benefit from an infusion of funding and possibly additional resources. However, a comprehensive, agency-wide planning effort, including planning for use of technology to leverage available resources, could help the SEC better determine the optimum human capital and funding needed to fulfill its mission.

Closing Comments

A number of witnesses who have recently appeared before this Committee and other Congressional committees to discuss Enron's failure have stated that our Nation's system of capital markets is recognized around the world as the best. I share that view. Our capital markets enjoy a reputation of integrity that promotes inves-

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[18] High performing organizations are organizations that have been recognized in the current literature or by the GAO as being innovative or effective in strategically managing their human capital.

[19] *Securities and Exchange Commission: Human Capital Challenges Require Management Oversight* (GAO–01–947, September 17, 2001).

tor confidence that is critical to our economy and the economies of other nations given the globalization of commerce. This reputation is now being challenged. The effectiveness of our systems of corporate governance, independent audits, regulatory oversight, and accounting and financial reporting, which are the underpinnings of our capital markets, to protect the public interest has been called into question by the failure of Enron. Many of the issues that are being raised have previously surfaced from other business failures and/or restatements of financial statements that significantly reduced previously reported earnings or equity. Although the human element factor, and the basic failure to always do what is right, are factors that can override systems of controls, it is clear that there are a range of actions that are critical to the effective functioning of the system underlying our capital markets that need attention. In addition, a strong enforcement function with appropriate civil and criminal sanctions is also needed to deal with noncompliance.

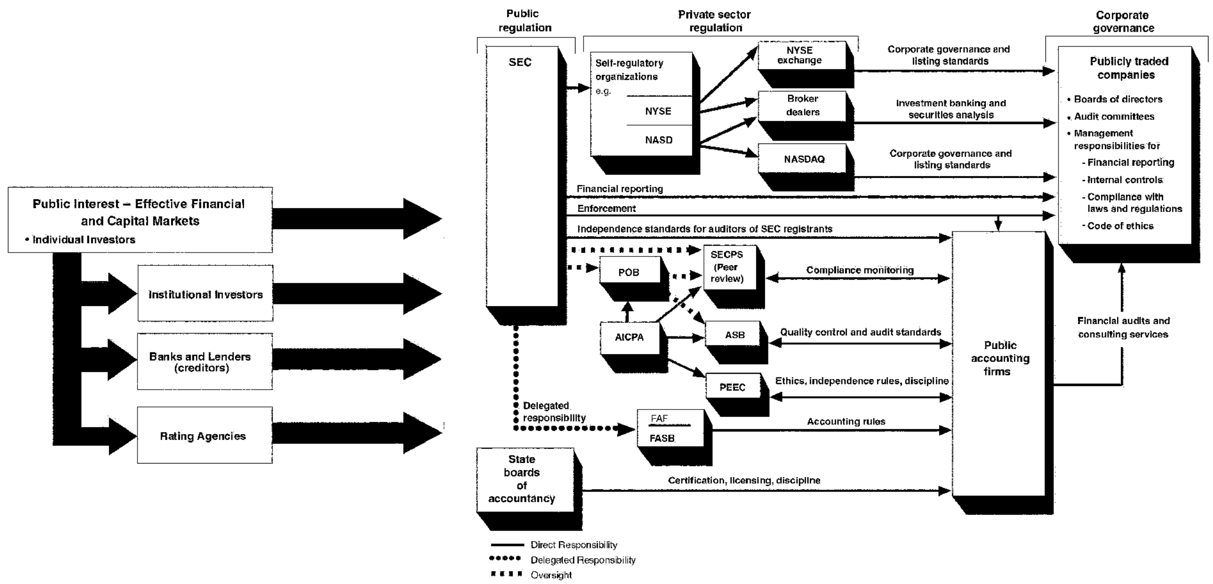
The results of the forum that we held last week on governance, transparency, and accountability identified major issues in each of the areas, which I have addressed in my remarks today, that endanger their effective functioning to protect the public interest. As is usually the case in issues of this magnitude and this importance, there is no single silver bullet to quickly make the repairs that are needed to the systems supporting our capital markets. The fundamental principles of having the right incentives, adequate transparency, and full accountability provide a good sounding board to evaluate proposals that are advanced. A holistic approach is also important as the systems are interrelated and weak links can severely strain their effective functioning. I have framed a number of the key issues today for Congressional consideration. As always, we look forward to working with you to further refine the issues, and develop and analyze options and take other steps designed to repair the system weaknesses that today pose a threat to investor confidence in our capital markets.

In summary, Enron's recent decline and fall coupled with other recent business failures pose a range of serious systemic issues that must be addressed. Effectively addressing these issues should be a shared responsibility involving a number of parties including top management, boards of directors, various board committees, stock exchanges, the accounting profession, standard setters, regulatory/oversight agencies, analysts, investors, and Congress. In the end, no matter what system exists, bad actors will do bad things with bad results. We must strive to take steps to minimize the number of such situations and to hold any violators of the system fully accountable for their actions.

Mr. Chairman, this concludes my statement. I would be pleased to answer any questions you or other Members of the Committee may have at this time.

GAO

Protecting the Public Interest: Overview of Regulatory and Private Sector Structure



Statement of David M. Walker, CPA
Comptroller General of the United States

" I believe that legislation that will provide a framework and guidance for the SEC to use in setting independence standards for public company audits is needed. History has shown that the AICPA and the SEC have failed to update their independence standards in a timely fashion and that past updates have not adequately protected the public's interests. In addition, the accounting profession has placed too much emphasis on growing non-audit fees and not enough emphasis on modernizing the auditing profession for the 21st century environment. Congress is the proper body to promulgate a framework for the SEC to use in connection with independence related regulatory and enforcement actions in order to help ensure confidence in financial reporting and safeguard investors and the public's interests."

" The independence provision contained in Chairman Sarbanes' bill is based on the original SEC independence proposal in calendar 2000 and the GAO's new independence standard that was issued in January 2002. The proposal strikes a reasoned and reasonable balance that will enable auditors to perform a range of non-audit services for their audit clients and an unlimited range of non-audit services for their non-audit clients. Most importantly, the proposed legislation adopts a "principle based" and "substance over form" approach that can stand the test of time and, if adopted, will better protect the public's interests. In my opinion, the time to act on independence legislation is now."

David M. Walker, CPA
Comptroller General of the United States

PREPARED STATEMENT OF ROBERT R. GLAUBER

CHAIRMAN AND CHIEF EXECUTIVE OFFICER
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

MARCH 5, 2002

Introduction

Chairman Sarbanes, Ranking Member Gramm, Members of the Senate Banking Committee, thank you for this opportunity to testify today on the vital, troubling, and timely issues of investor protection and accounting highlighted by the collapse of Enron. It would be hard to overstate the human tragedy for Enron's employees, pension-holders, and investors caused by the failure of America's seventh largest company.

Yet it is my firm hope that significant good can come of the collapse of Enron—in the form of better policies, oversight and regulatory structures to help restore the public's trust in the fairness of our markets. That is the purpose of today's hearing, and I am privileged to contribute my thoughts and the NASD's experiences to this Committee's thoughtful search for solutions.

Overview

Let me begin with a real quick overview of the NASD—because who we are bears directly on both the substance of what I will be saying and on the usefulness of the private sector self-regulatory model that we embody.

The National Association of Securities Dealers, NASD, is not a trade association, but rather, the world's largest self-regulatory organization, or SRO. Under Federal law, every one of the roughly 5,500 brokerage firms, nearly 90,000 branch offices and almost 700,000 registered representatives in the U.S. securities industry comes under our jurisdiction. To give you a sense of our scope and authority, it is vital to know that every brokerage firm in the United States that does business with the public *must* by law be a member of NASD. We have a staff of over 2,000 employees in Washington, Rockville, and district offices across the country and an annual budget exceeding $400 million.

For more than six decades, our mission and our mandate from Congress has been clear: To bring integrity to the markets and confidence to investors. We do this by licensing and setting qualification standards for industry participants, maintaining a massive registration database that includes qualification and disciplinary histories of all brokers and firms, writing rules to govern the conduct of brokerage firms and their employees, providing investor education and outreach, educating our members on legal and on ethical standards, examining them for compliance with the Federal securities laws and NASD and Federal rules, investigating infractions, and disciplining those who fail to comply.

The NASD's staffing and governance gives us independence from the industry, but we use industry expertise and resources extensively to accomplish our mission. The standards we set are not mere "best practices," but enforceable regulatory rules; violations may result in significant fines or even expulsion from the securities industry.

History of Securities Self-Regulation

The NASD's history to a great degree *is* the history of securities self-regulation in our country. The stock exchanges, options and futures markets have self-regulatory responsibilities, but they are centered on the trading that takes place within their respective markets and relate only to the members of their markets.

Self-regulation of the securities markets has deep roots in the United States.

The Securities Exchange Act of 1934 (Exchange Act or 1934 Act) is the legal foundation for self-regulation of the exchange markets. In that Act, Congress set up a system under which the New York Stock Exchange, the American Stock Exchange, and other securities exchanges, and through them their member seat holders, would form a regulatory front line for the newly created governmental regulator, the Securities and Exchange Commission (SEC).

Four years later, Congress felt that the market regulation focus of the 1934 Act was not sufficient and passed the Maloney Act of 1938. The Maloney Act authorized the formation and registration of national securities associations, which would supervise the conduct of their members subject to the oversight of the SEC.

In this way, Congress sought to "bring about self-discipline in conformity to law" and to foster "obedience to ethical standards" that went beyond the law. Senator Maloney intended that the securities industry "handle the problems of technical regulation," with the SEC "policing the submarginal fringe." The next year the National Association of Securities Dealers became the first—and still the only—registered national securities association.

From the creation in the 1930's, to strengthened SEC oversight of self-regulation in the 1970's, the industry and the Government have worked together successfully. The concept of self-regulation is now so ingrained in our capital markets' regulatory structure and the markets themselves are now so enormous in every sense of the word—the numbers of investors, the types of products, volume, and dollar value of trading—that it has become almost impossible to imagine their success without self-regulation.

This evolution has not been without its false steps. In 1996, the SEC criticized the NASD in part for putting its interests as the operator of Nasdaq ahead of its responsibilities as the regulator of the entire industry. The NASD's response was both decisive and instructive. It acted almost immediately to carve out NASD Regulation and the Nasdaq Stock Market (Nasdaq) as two distinct corporate entities, with separate Boards, management, and staff. And since then, we have taken this principle of independence even further, by spinning off Nasdaq *entirely*—with the sale of our last 27 percent of the company completed earlier this year.

While there were many other changes of less significance that resulted from the SEC's report with respect to the NASD, the bottom line was a much-strengthened role for the NASD's staff and a paring back of many roles traditionally played by the industry. Nonetheless, the active involvement of the industry in self-regulation has remained the mainstay of its success. And during the more than six decades since this system was established, investors worldwide have flocked to our markets.

The NASD's Responsibilities

The NASD has a comprehensive regime of regulatory duties. We writes rules to govern the conduct of our member firms, examine them for compliance with these rules, and discipline members if they fail to comply. Our market integrity services include professional testing and training, licensing and registration; examination of our member firms; investigation and enforcement; dispute resolution; and investor education. We also monitor all trading on Nasdaq, the largest volume market in the world, and other select securities and derivative markets.

Our Rulemaking Process

After an initial NASD staff determination that a rule or rule change is necessary to protect the public or strengthen market integrity, we begin a rigorous process to vet the rule and solicit industry and public input. The proposed rules or rule modifications are the result of input from our Board, industry, the SEC, consumer groups, the public, Congress, as well as arising from our own experience tracking markets and regulatory trends.

The NASD's rules must be approved by the SEC prior to becoming effective. Once a rule is finalized, our members are required to comply and put into place supervisory systems designed to achieve compliance with the new rule. NASD examiners, through routine cycle exams, surveillance monitoring and examinations for cause, evaluate firm compliance and recommend remedial actions by the firm, or disciplinary action by the NASD where compliance does not meet our standards.

Enforcement

Tough and even-handed enforcement is a fundamental part of NASD's mission. It not only ensures compliance and punishes wrongdoing, but also benefits the vast majority of our members who obey the rules and place investors first. For investors feel more confident using the markets when they know a tough cop is patrolling the beat. This is a fundamental aspect of our value to both the public and the industry.

On average, the NASD files more than 1,000 new disciplinary actions annually, with sanctions ranging from censures to fines and suspensions to expulsion from the securities industry. We supplement our enforcement efforts with referrals to criminal authorities and the SEC. In one important settlement alone this year, reached jointly with the SEC, the NASD, and the SEC each imposed sanctions of $50 million against a major investment bank for violating SRO rules by extracting illegal paybacks from favored customers to whom it allocated "hot" IPO's.

While this role as writer and enforcer of rules is familiar territory for this Committee, I would like to highlight some of the aspects of the NASD with which you may not be as familiar and some of the ways we carry out our regulatory functions.

For instance, we have created and we maintain a vast database of well over one million current and former registered representatives that enables us to provide the public with information on securities firms and professionals. This Central Registration Depository (CRD) is the largest such vehicle on the Internet. In 2001, we responded to over 2 million public disclosure inquiries. Using this same technology, we developed and operate through a contract with the SEC and State securities reg-

ulators the Investment Adviser Registration Depository (IARD). We have registered some 10,000 investment advisers through IARD.

It is also important to note that NASD Dispute Resolution is the largest dispute-resolution forum in the securities industry, with a docket that contains more than 90 percent of the cases in the industry.

And a point of particular importance to this Committee, considering its focus on financial literacy, is that we have an active Office of Individual Investor Education that brings increased attention and focus to this area of burgeoning importance.

Why NASD Works: Some "First Principles" for Private Sector Regulation

Private sector regulators bring to bear a keen practical understanding of the industry. They can tap industry expertise and resources that are not readily available to governments. They foster investor protection and industry involvement. And they foster higher standards that go beyond simply complying with the law.

Self-regulation works because the brokerage industry understands that market integrity leads to investor confidence, which is good for business. The overwhelming majority of the NASD's members comply willingly with the rules and the law. They view their own reputation for fair dealing and high standards as a competitive asset in a competitive industry.

Private sector regulators are uniquely qualified to identify and respond to emerging regulatory issues and keep their members appropriately informed. The NASD has developed a proactive program to ensure that members are timely apprised of emerging industry regulatory issues. Private sector regulators also are uniquely qualified to alert the general public to emerging regulatory issues. In this regard, the NASD has taken steps to reach out to the public through investor alerts and a host of written in-person and Internet-based investor education offerings.

All this explains how private sector regulation *can* work. But *why* specifically does it work well in the securities industry?

The first essential ingredient of the NASD's success is *independence.* At least half our Board of Governors are a nonindustry representative. And our large, experienced professional staff is not beholden to the industry.

Our governance structure relies on parties that have the *right incentives* to insist upon market integrity and investor confidence. Specifically, our Board includes representatives of the public, corporate issuers, and institutional investors, as well as the brokerage firms that make up our membership. The beauty of our system is that *all* these interests want markets that are fair, efficient, and safe. And no one stands to benefit from this more than the brokerage industry—which knows well that market integrity leads to investor confidence, which is good for business.

This leads to our next key attribute, which is *assured funding* from that part of the private sector having the greatest interest in our effectiveness. The right people pay for the NASD's services: Namely, the brokerage firms that profit from the investor confidence that stems from market integrity.

We are funded three ways: (1) through a gross assessment on firms based on their revenue; (2) a regulatory fee on every transaction that occurs on Nasdaq and on the InterMarket as our cost of regulating those trades generally; and (3) user fees, including various application costs and test fees, continuing education courses, and so forth. Every registered representative must also pay a small assessment when he or she registers.

This steady and sufficient funding means that we can afford the sophisticated technology, techniques, and infrastructure it takes to regulate a fast-changing, technology-intensive industry. NASD's technology budget exceeds $150 million per year. No private sector regulator can succeed without sufficient ways and means.

Another key to our success is that we have the *combined ability* to write rules, examine for enforcement of these rules and enforce the rules with teeth all under one roof. This consolidation of central regulatory functions reinforces our authority, competence, and credibility.

As was discussed in detail in the preceding section, the NASD is *empowered to discipline* our members with sanctions tough enough to punish violations and deter future misconduct. Last year, we brought more than 1,200 disciplinary actions, resulting in over 800 expulsions or suspensions from the industry. That is a powerful sanction—the ability to bar someone from earning a livelihood in his or her chosen field. In an average year we levy well in excess of $10 million in monetary sanctions. Of course, with authority comes responsibility. Just as our members are accountable to the NASD, so we are *accountable to the SEC.* Strong oversight by Government regulators protects investors by ensuring that someone is watching the industry watchdog.

What Desirable Features Congress Should Consider in Fashioning an Oversight System For the Accounting Industry

There are strong policy reasons to move in the direction of private sector regulator with strong SEC oversight for accounting. The advantages of such a solution over a purely governmental solution include the fact that when industry is involved, the regulator is able to tap private expertise in a way the Government cannot. And with industry assessed for the cost, the regulator can be better funded. This way the professional staff of lawyers, examiners, administrators, technologists, and analysts remain top notch and able to keep pace with industry. This model provides the best of both worlds: Tough SEC oversight of a well-funded, well-staffed, frontline private sector regulator.

While we would never presume to prescribe in detail what a new private sector regulator for the accounting industry should look like, we can, based on our analysis of what has been successful in the securities industry, illuminate the implications for such a body in the accounting industry, should Congress decide to move in this direction.

First, the private sector regulator should be an *independent* organization, with a sizable, professional staff, and sufficient technology and infrastructure to stay apace of the accounting profession. It should seek maximum industry input consistent with maximum industry accountability. And it should consolidate as many of the industry's central regulatory functions—especially in the areas of licensing, registration, examination, and strong enforcement—under one roof as is feasible. This will reinforce its authority, competence, and credibility all at once.

Second, it should have a *strong mandate* from the Government that sets its structure and empowers its enforcement arm with full authority to discipline the industry. Any form of private sector regulation must be empowered to effectively enforce the rules: The ability to levy meaningful fines, place conditions on continued participation in the industry, suspend, and where appropriate, banish those who misbehave from the industry. This "ultimate sanction" is both a powerful deterrent for would-be violators and an important investor protection.

Third, it should have a *governance structure* based on enlightened self-interest—namely, the need for effective auditing to produce numbers that investors can rely on and markets they can trust. This means a Board with interested parties much the same as the NASD's: Solid public companies that want investors to have confidence in their financial statements; institutional investors; broker-dealers; and the public—with accountants being a small minority.

Self-regulation does not mean that industry is left to its own devices. Public participation on an SRO Board is important not only to prevent any conflicts of interest, but also the appearance of such conflicts.

Fourth, it should have *assured funding* from some of these same self-interested parties, especially those with the biggest stake in the success of the system that have the most to gain from thorough, fair, and transparent accounting practices. The best candidates might be issuers (with a small fee on new share registrations, 10–K or 10–Q filings) and broker-dealers. And since they, of course, also have a major stake in the credibility of their audits, another source of funding could be examination fees charged to the accounting firms themselves.

An effective private regulatory system requires infrastructure, technology, and processes to provide quality, timely services. As we all know, monitoring compliance with accounting standards and principles in today's global economy is a complex and technology-intensive process. The regulator for the accounting profession must be equally up-to-date and technology-intensive.

And *finally,* it should be subject to strong, *appropriate oversight* from the SEC to institutionalize accountability. Oversight by Government regulators is essential to ensure the integrity of the process. It also provides an appropriate appellate forum for disciplinary actions.

Conclusion

Self-regulation in the securities industry has helped make the U.S. capital markets the most successful and respected in the world. This system was the legislative embodiment of the belief that additional protections were needed to "protect the investor and the honest dealer from dishonest and unfair practices by the submarginal element in the industry." These words are really the roots of the NASD's central rule: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

No one is under the illusion that the systemic flaws revealed by Enron can be set right without significant Government involvement. Even in the accounting industry, where *self*-regulation has suffered a bad name, there is a vital role to be

played by *private sector* regulation which fully understands the industry but is not co-opted by it; which commands respect with accountants and credibility with investors; and which allows the SEC to focus its scarce resources where they are most needed to police the honesty of the financial reporting that underpins the success of the U.S. capital markets.

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Nearly 70 years ago, Supreme Court Justice Harlan Stone memorably observed at the dedication of the University of Michigan Law School Quadrangle:

> I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that "a man cannot serve two masters." More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle. The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function. Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent, corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even the knowledge of their stockholders, reorganization committees created to serve interests of others than those whose securities they control, financial institutions which, in the infinite variety of their operations, consider only last, if at all, the interests of those whose funds they command, suggest how far we have ignored the necessary implications of that principle. The loss and the suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity are incalculable.[1]

The same year, 1934, that Justice Stone offered these observations, the Securities and Exchange Commission (SEC) began operations. By 1940, the SEC enforced six Federal securities laws.[2]

In the years since the SEC began operations, the U.S. securities markets have experienced an almost unimaginable growth and vitality.

The number of U.S. stockholders has increased from 1.5 million (or 1.2 percent of the population) in 1929 to 84 million (or 43.6 percent of the adult population) in 1998.[3] As long ago as 1980, 133 million U.S. citizens indirectly owned shares through such intermediaries as mutual funds or pension plans.[4]

When the stock market began its collapse in September 1929, the aggregate value of all shares on the New York Stock Exchange (NYSE) was approximately $90 billion.[5] By 2000, NYSE capitalization had grown to nearly $12.4 trillion.[6] Perhaps

[1] 48 Harv. L. Rev. 1, 8 (1934).

[2] There are now seven Federal securities laws: The Securities Act of 1933, 15 U.S.C. § 77a; the Securities Exchange Act of 1934, 15 U.S.C. § 78a; the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79; the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa; the Investment Company Act of 1940, 15 U.S.C. § 80a–1; the Investment Advisers Act of 1940, 15 U.S.C. § 80b–1; and the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa. For general description, see 1 Louis Loss & Joel Seligman, Securities Regulation 224–273 (3d ed. rev. 1998).

[3] Cf. Joel Seligman, The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation, 93 Mich. L. Rev. 649, 654 (1995); N.Y. Stock Exch., Fact Book, 55–56 (2000).

[4] Seligman, supra n.3, at 658.

[5] Joel Seligman, The Transformation of Wall Street 1 (rev. ed. 1995).

[6] Securities Indus. Assoc., 2001 Securities Industry Fact Book at 48.

most remarkably in 2000, over $2.3 trillion in new securities was sold in some 16,481 corporate underwritings and 3,540 private placements.[7]

Underlying these remarkable numbers was the longest sustained bull market in U.S. history. Focusing on year-end closing indexes, the Dow Jones Industrial Average rose from 875 in 1981 to 11,497 in 1999, paralleling similar surges in other leading composite indexes.[8] To put this in other terms, between 1981 and 1999, the New York Stock Exchange stock market capitalization increased nearly 11 fold from $1.1 to $12.3 trillion.[9]

With this unprecedented success there also appears to have come a lulling of our institutional sensibilities. A widespread belief appears to have evolved in the U.S. financial community that time honored rules such as those that discourage conflicts of interest are quaint and easily circumvented. Too frequently, in recent years, sharp practitioners in business, investment banking, accounting, or law appear to have challenged the fundamental tenets of "full disclosure of material information" or "fair presentation of accounting results." A deterioration in the integrity of our corporate governance and mandatory disclosure systems may well have advanced, not because of a novel strain of human cupidity, but because we had so much success, for so long, that we began to forget why fundamental principles of full disclosure and corporate accountability long were considered essential.

No recent case better illustrates this deterioration than Enron. Enron was an extraordinarily fast growing provider, primarily of natural gas, electricity, and communication products and services,[10] whose total assets quadrupled between 1996 and 2000 from $16.137 to $65.503 billion.[11] Its 2000 Form 10–K annual report filed with the SEC was a consistently upbeat review of its many claimed successes, only unusual because of Exhibit 21 to the certified financial statements which was a 49 page list of subsidiaries. In 2001, Enron was seventh on the Fortune 500 list, with revenues in 2000 of $100.8 billion.[12]

Then, abruptly, essentially without warning, Enron melted down. A November 8, 2001 Form 8–K stunningly stated: "Enron intends to restate its financial statements for the years ended December 31, 1999 through 2000 and the quarters ended March 31 and June 30, 2001. As a result the previously issued financial statements for those periods and the audit reports covering the year-end financial statements for 1992 to 2000 should not be relied upon."[13]

This Committee, I know, is already familiar with the Enron Special Investigative Committee Report [Powers Report], chaired by University of Texas Law School Dean William Powers. Let me not here revisit its fact finding. I would like, however, to augment one type of fact finding made by the Special Investigative Committee.

The Powers Report was critical of the required public disclosure of the LJM partnerships which it characterized as systematically inadequate.[14] In Note 16 to the Enron Corporation 2000 Form 10–K, related party transactions are described in these terms:

> In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.
>
> In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly formed entities (the Entities) assets valued

[7] Id. at 12.
[8] Id. at 54.
[9] Id. at 48.
[10] Enron Corp. Form 10–K Item 1—Business General.
[11] Id., Item 6—Selected Financial Data.
[12] *Fortune,* April 16, 2001 at F–1.
[13] Item 5, Enron Corp. Form 8–K (November 8, 2001).
[14] [T]hese disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not communicate the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and, in some respects, to disguise their substance and import. The disclosures also asserted that the related-party transactions were reasonable compared to transactions with third parties, apparently without any factual basis. The process by which the relevant disclosures were crafted was influential substantially by Enron Global Finance (Fastow's group). There was an absence of forceful and of effective oversight by Senior Enron Management and in-house counsel, and objective and critical professional advice by outside counsel at Vinson & Elkins, or auditors at Andersen. Id. at 17.

at approximately $1.2 billion, including $150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately $309 million, including a $50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron's equity method investee. In return, Enron received economic interests in the Entities, $309 million in notes receivable, of which $259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of $1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of $172.6 million is invested in Enron's demand notes. In addition, Enron paid $123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron $10.7 million to terminate the share-settled options on 14.5 million shares of Enron's common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

The first paragraph is an exercise in obfuscation. What transactions? How much money is involved? What risk is there to Enron? Who is the senior officer of Enron? How much is he or she paid? Who are the limited partners? What basis is there for management's belief that the terms of these transactions "were reasonable compared to those which could have been negotiated with unrelated parties?" The second paragraph is more detailed but it is equally confusing. Why did Enron enter into these transactions? Who is the Related Party? What risk does Enron bear?[15]

There were other significant public disclosure issues that the Powers Report did not address in the same detail as it did related party transactions. The Report, for example, noted that the LJM2 entities had approximately 50 limited partners, "including American Home Assurance Co., Arkansas Teachers Retirement System, the MacArthur Foundation, and entities affiliated with Merrill Lynch, J.P. Morgan, Citicorp, First Union, Deutsche Bank, G.E. Capital, and Dresdner Kleinworth Benson."[16] Newspaper accounts have raised the quite troublesome possibility that at least some of these limited partners had been shown different financial statements than were publicly disclosed.[17]

The Enron debacle has raised fundamental policy and regulatory questions, notably including the following in corporate and securities law:

(1) Perhaps most significant is the empirical question: Was Enron an isolated, but serious, breakdown or are the problems exposed there more widespread? By early February 2002, newspapers were reporting a market wide dampening of stock prices because of uncertainty whether the accounting, auditing, and corporate governance problems at Enron would prove widespread.[18] One article reported: "Last year, a study by Financial Executives International, a trade group for corporate executives, found that public companies had revised their financial results 464 times between 1998 and 2000, nearly as many restatements as in the 20 previous years combined, and the problem probably worsened last year."[19]

Nonetheless, the hard empirical work to gauge the magnitude of dysfunction either at Enron or generally is far from complete. The more we learn about incidence, types of dysfunction, and the causes of dysfunction, the more intelligently we can consider remedies. We are still very far away from a comprehensive analysis

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[15] The Powers Report concluded: Overall, Enron failed to disclose facts that were important for an understanding of the substance of the transactions. The Company did disclose that there were large transactions with entities in which the CFO had an interest. Enron did not, however, set forth the CFO's actual or likely economic benefits from these transactions and, most importantly, never clearly disclosed the purposes behind these transactions or the complete financial statement effects of these complex arrangements. The disclosures also asserted without adequate foundation, in effect, that the arrangements were comparable to arm's-length transactions. We believe that the responsibility for these inadequate disclosures is shared by Enron Management, the Audit and Compliance Committee of the Board, Enron's in-house counsel, Vinson & Elkins, and Andersen. Id. at 178.

[16] Id. at 73.

[17] A Fog Over Enron, and the Legal Landscape, *N.Y. Times,* January 27, 2002. Cf. McGeehan, Enron's Deals Were Marketed to Companies by Wall Street, *N.Y. Times,* February 14, 2002 at C1.

[18] Berenson, The Biggest Casualty of Enron's Collapse of Confidence, *N.Y. Times,* February 10, 2002 at §4 at 1.

[19] Ibid.

of Enron. Systematic review of other company's SEC filings can reveal similar patterns of dysfunction, but not all, particularly, if like Enron, a key problem is unreported off balance sheet transactions.

The first and most urgent need in the wake of Enron is not solutions, but facts.

(2) Will the type of problem illustrated by Enron prove self-correcting, at least for the foreseeable future? Already there appear to be underway SEC, Justice Department, and private investigations or litigation. The SEC has now begun a series of regulatory initiatives, including proposed changes in corporate disclosure rules, that, among other points, significantly broaden the list of significant events that require current disclosure on Form 8–K.[20] Inevitably, without further legislative or regulatory action, it is reasonable to anticipate enhanced board review of transactions, more detailed and precise disclosure in SEC filings, more demanding internal accounting controls and outside audits, and more skeptical investment analyst reports.

It is too early to judge whether voluntary steps will suffice. We need both to better understand the problems involved and what voluntary steps will occur. There will be other steps from the self-regulatory organizations such as the NYSE that also need to be taken into account.[21]

A caveat is in order here. Voluntary steps often work well when there is a mood of crisis or a fear of legislation or regulation. There is a different type of uncertainty regarding whether voluntary steps will endure after a crisis mood has abated.

(3) If structural or standard reform does prove necessary, there appears to be broad support for focusing on accounting standard setting and auditing regulation. In mid-January 2002 SEC Chairman Harvey Pitt proposed a new industry organization that will oversee auditor discipline.[22] In response, the Public Oversight Board, shortly later, voted to disband because of concern it was being "shunted aside."[23] Regardless of the fate of the POB the time seems ripe for a systematic review of accounting standard setting by the FASB, auditing oversight by the POB and other private and State agencies, and accountant independence.[24]

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[20] SEC to Propose New Corporate Disclosure Rules, Press Rel. 2002–22 (February 13, 2002). This Press Release explained in part:

The Commission believes that markets and investors need more timely access to a greater range of important information concerning public companies than what is required by the existing reporting system. Accordingly, the Commission intends to expand the types of information that companies must report on Form 8–K. Some of the items that the Commission is evaluating for inclusion in these reports include:

- Changes in rating agency decisions and other rating agency contacts.
- Transactions in the company's securities, including derivative securities, with the executive officers and directors.
- Defaults and other events that could trigger acceleration of direct or contingent obligations.
- Transactions that result in material direct or contingent obligations not included in a prospectus filed by the company with the Commission.
- Offerings of equity securities not included in a prospectus filed by the company with the Commission.
- Waivers of corporate ethics and conduct rules for officers, for directors, and for other key employees.
- Material modifications to rights of security holders.
- The departure of the company's CEO, CFO, COO, or president (or persons in equivalent positions).
- Notices that reliance on a prior audit is no longer permissible, or that the auditor will not consent to use of its report in a Securities Act filing.
- Definitive agreement that is material to the company. . . .
- Any loss or gain of a material customer or contract.
- Any material write-offs, restructurings, or impairments.
- Any material change in accounting policy or estimate.
- Movement or de-listing of the company's securities from one quotation system or exchange to another.
- Any material events, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement, and stock ownership plans.

Given the significance of current disclosure of these events to participants in the secondary markets, the Commission intends to propose that companies file reports of these events no later than the second business day following their occurrence. The Commission also is considering whether some of these events require filing by the opening of business on the day after the occurrence of the event.

[21] See, e.g., SEC Review of Corporate Governance, Conduct Rules, SEC Press Rel. 2002–23 (February 13, 2002).

[22] See Schroeder, SEC Proposes Accounting Disciplinary Body, *Wall Street Journal,* January 17, 2002 at C1; Pitt Elaborates on Proposal for New Board to Govern Accountants, Asks for Dialogue, 34 Sec. Reg. & L. Rep. (BNA) 153 (2002).

[23] In Protest, POB Votes to Disband; Panel to Consider SEC Chief's Urging Reversal, 34 Sec. Reg. & L. Rep. (BNA) 154 (2002).

[24] See, e.g., former SEC Chairman Levitt Renews Call for Additional Restrictions on Auditing Firms, 34 id. 155; Accounting Debacles Spark Calls for Change: Here's the Rundown, *Wall Street*

The need for significant reform of the accounting profession has been particularly stressed in recent Congressional hearings.[25]

It is worth disaggregating several specific issues.

- The off balance sheet transactions that Enron employed were made in accordance with generally accepted accounting standards. This has appropriately focused attention on the quality of the existing accounting standard setting organization, the Financial Accounting Standards Board (FASB). Long before Enron, the political and financial weaknesses of the FASB were much discussed. As former SEC Chairman David Ruder has stated:

> Despite its attempts to seek the views of the business community, the FASB faces difficulty in obtaining financing from business, which often objects to FASB standards that affect business interests. The FASB is financed through sales of its work product and through contributions by accounting firms and businesses. When businesses do not like the FASB's standards or its process for creating then, they sometimes withdraw financial support, or fail to provide it in the first place. The FASB continually faces difficulties in financing its operations. The accounting profession is supportive, but generally speaking business is not. Institutional investors and investment bankers, who benefit greatly from financial statement disclosures, contribute little to the FAF, creating a classic free rider problem.

I believe the solution to the financial pressures on the FASB would be to provide a system of financing . . . FASB should be financed by payments by preparers and users of financial statements. If a voluntary system cannot be established, Congress should enact legislation creating financing for the FASB.[26]

Paul A. Volcker, now Chair of the International Accounting Standards Committee Foundation, similarly has testified:

> . . . [P]roblems, building over a period of years, have now exploded into a sense of crisis. That crisis is exemplified by the Enron collapse. But Enron is not the only symptom. We have had too many restatements of

Journal, February 6, 2002 at C1; Leonhardt, How Will Washington Read the Signs? *N.Y. Times,* February 10, 2002 at § 3 at 1.

[25] Former SEC Chairman Roderick M. Hills, for example, testified on February 12, 2002 to the Senate Committee on Banking, Housing, and Urban Affairs:

. . . The system itself needs a major overhaul. The head of NYU's Accounting Department, Paul Brown, put it well:

"It is the old adage of a F.A.S.B. rule. It takes 4 years to write it, and it takes 4 minutes for an astute investment banker to get around it."

Second, it is increasingly clear that the accounting profession is not able *consistently* to resist management pressures to permit incomplete or misleading financial statements, and the profession has serious problems in recruiting and keeping the highly qualified professionals that are needed.

Third, the audit committees of too many boards are not exercising the authority given to them or the responsibility expected of them. . . .

The financial papers produced dutifully each year by publicly-traded companies have become a commodity. Companies produce them largely because they are required to do so. Few CEO's regard this work product as having any intrinsic value. Accounting firms compete for business more on price than on the quality of their personnel or procedures.

If a company does take an interest in the structure of its balance sheet and profit and loss statement, it is far more likely to be caused by a desire to be innovative in how they report their profits than in the quality of the auditor's work. They hire bankers and consultants to design corporate structures that will give them a stronger looking balance sheet and, perhaps, keep the profits and losses of related companies off of their financial papers.

Senate Committee on Banking, Housing, and Urban Affairs, Hearing on "Accounting and Investor Protection Issues Raised in Enron and Other Public Companies," February 12, 2002 (Testimony of Roderick M. Hills) at 1–2.

[26] Senate Committee, supra n. 25 (Testimony of David S. Ruder) at 5–6.

After the bankruptcy of Enron in December 2001, SEC Chairman Harvey Pitt published How to Prevent Future Enrons, *Wall Street Journal,* December 11, 2001 at A18, which stated in part:

- *Private-sector standard setting that responds expeditiously, concisely and clearly to current and immediate needs.* A lengthy agenda that achieves its goals too slowly, or not at all, like good intentions, paves a road to the wrong locale.
- *An effective and transparent system of self-regulation for the accounting profession, subject to our rigorous, but nonduplicative, oversight.* As the major accounting firm CEO's and the American Institute of Certified Public Accountants recently proposed, the profession, in common with us, must provide assurances of comprehensive and effective self-regulation, including monitoring adherence to professional and ethical standards, and meaningfully disciplining firms or individuals falling short of those standards. Such a system has costs, but those who benefit from the system should help absorb them.

See also Pitt Renews Call for Modernization of Disclosure, Regulatory Processes, 33 Sec. Reg. & L. Rep. (BNA) 1630 (2001).

earnings, too many doubts about "pro forma" earnings, too many sudden charges of billions of dollars to "good will," too many perceived auditing failures accompanying bankruptcies to make us at all comfortable. To the contrary, it has become clear that some fundamental changes and reforms will be required to provide assurance that our financial reporting will be accurate, transparent, and meaningful.[27]

Congress or the SEC should systematically review the process and substance of accounting standard setting. It is urgently necessary to restore and strengthen the fundamental premise that financial statements will provide a "fair presentation" of an entity's financial position. This both involves addressing specific disclosure items such as off balance sheet transactions, stock options, and derivatives and strengthening the independence of accounting standard setting. The key here, as elsewhere, is money. You cannot expect a Government agency or private entity to be truly independent without an assured source of funds. Congress should explore means to legislate a user or accounting firm fee system that will provide such independence.

- Enveloping Generally Accepted Accounting Principles is the SEC mandatory disclosure system. The mandatory disclosure system deserves to be under sharp question. How could financial reporting practices sufficient to bankrupt the seventh largest industrial firm in the country so long go undisclosed? Is this simply an isolated instance of bad disclosure practices or is Enron suggestive of more systematic failure?

The SEC has begun to grapple with the latter, more disturbing possibility. In December 2001 the Commission issued a cautionary Release on "pro forma" financial information,[28] rapidly followed by a similar statement regarding the selection and disclosure of critical accounting policies and practices,[29] and in January 2002 by a consequential and broad new interpretation of the pivotal management discussion and analysis disclosure item.[30]

More needs to be done. The Commission and Congress should carefully review whether SEC oversight of the Generally Accepted Accounting Principles and the context of its mandatory disclosure system has unacceptably deteriorated.

The Commission also needs to seriously and patiently review whether we today have the right construct of disclosure requirements, proceeding item by item, and whether changes in timing and delivery of data would be appropriate given evolving changes in technology and international securities trading.

- At its core Enron involved an audit failure. The outside auditor both appeared to operate with significant conflicts of interest and to have been too beholden to a highly aggressive corporate management.

Several aspects of the Enron audit failure deserve particular attention.

First, the Public Oversight Board, primarily responsible for overseeing the SEC's auditors, has been much criticized. Former SEC Chairman Harold Williams, for example, recently stated:

> The Public Oversight Board was created by the profession during my Chairmanship as an effort at self-regulation. We expressed concern at the time whether the peer review process administered by the profession would be adequate. But as believers in the principle of self-regulation, we concluded that the Board should have the opportunity to prove itself. In my opinion, the events over the intervening years have demonstrated that it does not meet the needs and is not adequate. Under the peer review system adopted in 1977, the firms periodically review each other. To my knowledge, there has never been a negative review of a major firm. However, the peer review is not permitted to examine any audits that are subject to litigation. The reviews focus on the adequacy of quality control procedures and do not examine the audits of companies to see if the peer would have arrived at a different conclusion. Peer review has proved itself insufficient. Particu-

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27 Senate Committee, supra n. 25 (Testimony of Paul A. Volcker, February 14, 2002) at 1.

28 Sec. Act Rel. 8039, 76 SEC Dock. 896 (2001).

29 Sec. Act Rel. 8040, 76 SEC Dock. 983 (2001).

30 Sec. Act Rel. 8056, ____ SEC Dock. ____ (2002).

This Commission statement delineated additional disclosure that should occur concerning (1) off balance sheet arrangements, (2) commodity contracts, including those indexed to measures of weather, commodity prices, or quoted prices of service capacity, such as energy and bandwidth capacity contracts; and (3) related party transactions. The Commission statement was premised on the assumption that Item 303(a) of Regulation S–K already requires disclosure of "known trends" or "known uncertainties" that could result in a registrant's liquidity or capital resources increasing or decreasing in a material way.

larly as the Big Eight has become only the Big 5, peer review in its present form becomes too incestuous. A system needs to be established which is independent of the accounting profession, transparent and able to serve both effective quality control and disciplinary functions.

Further, the Board is not adequately funded and is beholden for its funding to the very people it is supposed to oversee. I suggest that the SEC consider a requirement that a percentage of the audit fees of public companies be assessed to pay for independent oversight, whether it is the Public Oversight Board or a successor body, so that its funding is assured.[31]

The former SEC Chairman David Ruder would go further and replace the POB with "a new body which will be separate from the AICPA and whose board will be composed entirely of public members who have no connection to the accounting profession."[32]

I believe at this time a new auditing self-regulatory organization is necessary. It should replace not just the POB, but also a Byzantine structure of accounting disciplinary bodies which generally have lacked adequate and assured financial support; clear and undivided responsibility for discipline; and an effective system of SEC oversight. The success of such a new SRO will be in careful attention to detail. I would recommend:

- A legal structure similar to that in Sections 15A and 19 of the Securities Exchange Act which apply to the securities associations and other securities industry self-regulatory organizations and addresses such topics as purposes, powers, and discipline.[33]
- A clear scope provision articulating which auditors should be subject to the new SRO and a mandate that they be subject to the SRO.
- A privilege from discovery of investigative files to facilitate auditing discipline during the pendency of other Government or private litigation.
- Crucially the new SRO should be permitted, subject to SEC oversight, to adopt new auditing standards that can evolve over time. These rules would be limited by SEC rulemaking and, of course, Congressional legislation.
- As with the accounting standard setting body a pivotal decision involves funding. To effectively operate over time any new auditing SRO must have an assured source of funding. The most logical basis of such funding may prove to be a Congressionally mandated fee on covered auditing firms.
- The new SRO will need to draw on the expertise of the accounting profession to ensure technical proficiency. A supervisory board with a minority of industry representatives and a majority of public representatives may prove to be an appropriate balance. The chair of such a board, however, should be a public member.
- I believe the most significant issue may prove to be who conducts periodic examinations and inspections. To paraphrase the classical adage: Who will audit the auditors? I would urge serious consideration be devoted to replacing peer review with a professional examination staff in the new SRO. Peer review has been, to some degree, unfairly maligned. But even at its best it involves competitors reviewing competitors. The temptation to go easy on the firm you review lest it be too critical of you is an unavoidable one. While the inspection processes of the New York Stock Exchange and the NASD Reg are not panaceas, then suggest a workable improvement.
- Finally, it may prove particularly wise to statutorily replicate § 15(b)(4)(E) of the Securities Exchange Act which can impose liability on a broker-dealer who has "failed reasonably to supervise." Particularly in firms with as many offices as the leading auditing firms, a clearly delineated supervision standard strikes me as vital to effective law compliance.

Second, a separate, not mutually exclusive approach, would be to require mandatory rotation of auditors at specific intervals such as 5 or 7 years.[34]

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[31] Senate Committee, supra n. 25 (Testimony of Harold M. Williams) at 3.

[32] Senate Committee, supra n. 25 (Testimony of Ruder) at 4. Ruder explains in ibid:

The POB has functioned well in the past, and there is much to learn from its organization and operations. However, although the POB's powers have been strengthened, it does not have sufficient budget to allow it to function effectively. It does not have the power to force accounting firms to provide the documents necessary to complete investigations, nor does it have the power to promise that documents received will be protected against discovery in private litigation. It is forced to rely upon the accounting profession itself to engage in enforcement activities. Most important, its connection to the AICPA creates an appearance of control by that body.

[33] 6 Louis Loss & Joel Seligman, Securities Regulation 2692–2723, 2787–2830 (3d ed. 1990).

[34] Former SEC Chairman Harold Williams has advocated this approach:

Continued

Third, particular attention has been devoted to the wisdom of separating accounting firm audit services from consulting. One early result of Enron has been an acceleration of this process by voluntary means in the Big 5 accounting firms.[35] Congress or the SEC should consider whether a statute or regulation should require such separation and, if so, how best to define which consulting services and which accounting firms should be subject to the new law or rule.

Fourth, a key SEC reform of the 1970's, the Board of Directors audit committee, has also been sharply criticized for its ineffectuality. Former SEC Chairman Roderick Hills, during whose term in 1977, the New York Stock Exchange adopted the requirement of the independent audit committee was both detailed in his delineation of shortcomings and in his proposed solutions:

- Audit committees may consist of people who satisfy the objective criteria of independence, but their election to the board is too often the whim of the CEO, who decides each year who will sit on the audit committee and who will chair it.
- Audit committees too often seek only to reduce the cost of the audit rather than to seek ways to improve its quality. They do not play a sufficient role in determining what the fair fee should be.
- Audit committees seldom ask the auditor if there is a better, fairer way to present the company's financial position.
- Audit committees seldom play a role in selecting a new audit firm or in approving a change in the partner in charge of the audit. They may well endorse an engagement or the appointment of a new team, but they are not seen as material to the selection process.
- Audit committees seldom establish themselves as the party in charge of the audit.

Congress may wish . . . to require that:

- Corporations of a certain size with publicly-traded stock have an effective, independent audit committee in order to avoid a finding that there is a material weakness in the corporation's internal controls.
- Corporations of a certain size have an independent nominating committee with the authority to secure new directors and appoint all members of the audit committee.
- Audit committees be solely responsible for the retention of accounting firms and be responsible for the fees paid them.[36]

I believe former Chairman Hills proposals should be seriously considered.

(4) A separate principal culprit at Enron was a dysfunctional corporate management, broadly potentially including senior executives, the board, board committees, internal accounting systems, the outside auditor, and both internal and outside legal counsel.[37] The genius of U.S. corporate law, if genius there be, is its redundant sys-

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I would urge the Commission to consider a requirement that a public company retain its auditor for a fixed term with no right to terminate. This could be for 5 years or perhaps the Biblical seven. After that fixed term, the corporation would be required to change auditors. As a consequence of such a requirement, the auditor would be assured of the assignment and, therefore, would not be threatened with the loss of the client and could exercise truly independent judgment. Under such a system the client would lose its ability to threaten to change auditors if in its judgment the assigned audit team was inadequate. It would also reduce the client's ability to negotiate on fees, and almost certainly the audit would cost more. The required rotation of auditors would also involve the inefficiency of the learning curve for the new auditor. I view all of these potential costs acceptable if it reinforces the auditor's independence and makes the work more comprehensive. The client could be given a right to appeal to a reconstituted independent oversight organization if it believes that it is not well served by its auditor and needs some relief. Senate Committee, supra n. 56 (Testimony of Williams) at 2.

[35] Former Chairman David Ruder thoughtfully explained:

One of the substantial worries regarding the Andersen audit of Enron has been that Andersen not only audited Enron, but also was paid approximately the same amount for nonaudit services. It has been reported that in the year 2000 Andersen was paid audit fees of approximately $25 million and nonaudit fees of approximately $27 million. Comparisons of the amounts of audit fees to nonaudit fees for a range of companies and auditors have revealed ratios of nonaudit to audit fees ranging as high as nine to one. The expressed general concern is that an audit cannot be objective if the auditor is receiving substantial nonaudit fees.

The accounting profession seems to have recognized that management consulting services, which involve accounting firms in helping management make business decisions, should not be performed for an audit client. Three of the Big 5 accounting firms (Andersen, Ernst & Young, and KPMG) have now separated their management consulting units from their audit units by contractual splits and spinoffs, and a fourth (PricewaterhouseCoopers) has announced its intention to split off its management consulting unit in a public offering. (*Wall Street Journal*, p. 3, January 31, 2002) The fifth firm should also do so, or at least refrain from offering management consulting services to audit clients. Senate Committee, supra n. 25 (Testimony of Ruder) at 2.

[36] Senate Committee, supra n. 25 (Testimony of Hills) at 5, 8.

[37] As former SEC Chairman David Ruder testified:

tems of corporate accountability. The Board is intended to monitor the principal executives. Outside accountants and outside legal counsel are supposed to buttress this accountability system as are a series of legal devices, most notably including board and executive potential liability for false and misleading filings with the SEC and State corporate law negligence liability.

The overlapping accountability systems can individually fail. What made Enron unusual is that they all appeared to fail simultaneously.

I am skeptical that similar simultaneous dysfunction will prove widespread.

I am also mindful that poorly designed new regulatory solutions could stultify the type of product innovation and risk-taking that has been consequential to the recent growth of the U.S. economy. I am also aware that corporate governance has largely been addressed by State corporate law.

At the Federal level, I anticipate that reforms related to the dysfunction in Enron management will be indirect, based on the more effective use of the mandatory disclosure system and litigation, rather than direct such as proposals for the SEC to audit each registered firm or select directors. Among other proposals that should be thoughtfully reviewed will be:

First, increasing the size of the SEC staff to increase the number of filings reviewed and enforcement investigations conducted.[38]

Second, considering whether to strengthen private enforcement of the Federal securities laws by reviewing whether the Private Securities Litigation Reform Act of 1995 has deterred or needlessly delayed meritorious lawsuits.[39]

Third, considering whether it would be wiser to permit private aiding and abetting actions against attorneys and auditors and reverse through legislation the 1994 U.S. Supreme Court decision in *Central Bank,*[40] which held that such actions could not be implied from the key Federal securities law fraud remedy, Securities Exchange Act Rule 10b–5.[41]

(5) One step removed from Enron, but strongly suggested by its failure are serious questions of the integrity of investment analysts. As former SEC Chairman Arthur Levitt, Jr. emphatically testified in February 2002:

> . . . For years, we have known that analysts' compensation is tied to their ability to bring in or support investment banking deals. In early December, with Enron trading at 75 cents a share, 12 of the 17 analysts who covered Enron, rated the stock either a hold or buy.
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> Two years ago, I asked the New York Stock Exchange and the National Association of Securities Dealers to require investment banks and their analysts to disclose clearly all financial relationships with the companies they rate. Last week, we finally saw a response from the self-regulators. But it is not enough. Wall Street's major firms—not its trade group—need to take immediate steps to reform how analysts are compensated. As long as ana-

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The primary fault in the Enron failure seems to be poor management. From all accounts it appears that Enron became overly aggressive in its efforts to dominate the energy trading markets, engaged in highly leveraged off balance sheet financing, engaged in extremely aggressive accounting, overstated its earnings, failed to disclose the true nature of its corporate and financial structure, and eventually lost the confidence of its creditors and trading counter parties. Enron management appears to be primarily to blame. . . .

. . . the Enron problems represent a failure in corporate governance. One striking aspect of this failure is Enron's apparent lack of respect for the accounting system that underlies financial reporting. Enron seems to have purposely attempted to avoid disclosure of its true finances. Instead it should have utilized the accounting system as a means of assisting it to make sound management decisions and as a source of information helping it to provide the securities markets with a truthful statement of financial condition. Senate Committee, supra n. 25 (Testimony of Ruder) at 6–7.

Similarly former Chairman Hills observed:

Finally, it must be said on this point that unless one has been subjected to a serious corporate meltdown, you cannot possibly appreciate the enormous discretion that management has under GAAP to present its financial position. By changing depreciation schedules, by using different estimates or by adopting different strategies or assumptions, a company can make enormous changes in its annual income. Management too often makes these "top-level" adjustments without adequate disclosure to the public about how much their current earnings depend on such adjustments. A corporate meltdown in which I was involved 3 years ago was caused by top-level adjustments that accounted for 40 percent of the company's total income and led to a corporate admission that billions of dollars of income had been improperly reported. Senate Committee, supra n. 25 (Testimony of Hills) at 3.

[38] Cf. Norris, Will SEC's Needs Be Met? Not by Bush, *N.Y. Times,* February 8, 2002 at C1.

[39] See 10 Louis Loss & Joel Seligman, Securities Regulation 4636–4669 (3d ed. rev. 1996).

[40] *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994).

[41] 9 Louis Loss & Joel Seligman, Securities Regulation 4479–4488 (3d ed. 1992 & 2001 Ann. Supp.).

lysts are paid based on banking deals they generate or work on, there will always be a cloud over what they say.[42]

Congress should broadly investigate whether investment banks have adequately maintained "Chinese walls" between the retail brokerage and underwriting and whether, more fundamentally, securities firms that underwrite should be separated from retail brokerage.[43] These are not new questions[44] but they have been revived by Enron. I am very skeptical that separation here will prove wise. But to put the matter bluntly, the quality of investment advice has raised fundamental questions.

An alternative approach worth considering would be a new form of adviser liability for recommendations without a reasonable basis. Increased SEC inspection cycles to review the basis of adviser recommendations is also now in order.

Conclusion

There will be other proposals, both within the framework of corporate and securities law and without, no doubt, that should receive serious consideration. At its core Enron was a triumph of aggressive and of financial chicanery over time honored concepts such as "fair presentation" of financial information and "full disclosure" of material information. After thoughtful and diligent investigation, I anticipate at least one inevitable result. Our traditional commitment to avoiding or fully disclosing conflicts of interest will be systematically reinvigorated.

PREPARED STATEMENT OF JOHN C. COFFEE, JR.

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MARCH 5, 2002

Introduction

I want to thank the Committee for inviting me to appear today. Because I realize that you are covering a broad range of issues and have only limited time to listen to any individual witness, I believe that my contribution will be the most useful if I focus on just two issues: (1) What powers, duties, and standards should Congress include in any legislation that establishes a self-regulatory body to oversee the auditing profession? and (2) How should Congress respond to the evidence that conflicts of interest do bias the recommendations and research of securities analysts?

If we focus only on Enron, it cannot prove by itself that there is a crisis or that either auditors or securities analysts have been compromised by conflicts of interest. By itself, Enron is only an anecdote—bizarre, vivid, and tragic as it may be. But Enron does not stand alone. As I elaborated in detail in testimony before the Senate Commerce Committee on December 17, 2001 (and thus will not repeat at any length here), Enron is part of a pattern. As the liabilities faced by auditors declined in the 1990's and as the incentives auditors perceived to acquiesce in management's desire to manage earnings increased over the same period (because of the opportunities to earn highly lucrative consulting revenues), there has been an apparent erosion in the quality of financial reporting. Assertive as this conclusion may sound, a burgeoning literature exists on earnings management, which indicates that earnings management is conscious, widespread, and tolerated by auditors within, at least, very wide limits.[1] Objective data also shows a decline in the reliability of published financial results. To give only the simplest quantitative measure, from 1997 to 2000, there were 1,080 earnings restatements by publicly-held companies.[2] Most importantly, there has been a significant recent increase in the number of earnings restatements. Earnings restatements averaged 49 per year from 1990 to 1997, then

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[42] Senate Committee, supra n. 56 (Testimony of Arthur Levitt, Jr.) at 2.

[43] Wayne, Congress's Scrutiny Shifts to Wall Street and Its Enron Role, *N.Y. Times,* February 19, 2002 at A1.

[44] See, e.g., 6 Louis Loss & Joel Seligman, Securities Regulation 2977–2980 (3d ed. 1990). (Proposed segregation of brokerage and underwriting in 1930's), 8 Louis Loss & Joel Seligman, Securities Regulation 3618–3631 (3d ed. 1991) (Chinese Wall).

[1] I summarize much of this literature and the absence of any meaningful effort at internal self-discipline in a recent article. See Coffee, *The Acquiescent Gatekeeper: Reputational, Intermediaries, Auditor Independence and the Governance of Accounting* (2001). This article, written well before the Enron story broke, is available on the Social Science Research Network (SSRN) at *www.ssrn.com* at id=270994.

[2] See George Moriarty and Philip Livingston, "Quantitative Measures of the Quality of Financial Reporting," 17 Financial Executive 55 (July 1, 2001).

increased to 91 in 1998, and soared to 150 in 1999 and 156 in 2000.[3] Put simply, this sudden spike in earnings restatements is neither coincidental nor temporary.

Worse yet, the accounting profession is conspicuous by its lack of any meaningful mechanism for internal self-discipline. This void contrasts starkly with the governance structure of the broker-dealer industry, where the National Association of Securities Dealers (NASD) administers a vigorous and effective system of internal discipline. Because both brokers and auditors ultimately serve the same constituency—for example, investors—this disparity is unjustifiable. Put simply, American corporate governance depends at bottom on the credibility of the numbers. Only if financial data is accurate can our essentially private system of corporate governance operate effectively. Today, there is doubt about the reliability of reported financial data—and also about the independence and objectivity of the two watchdogs who monitor and verify that data: Namely, auditors and securities analysts.

What should Congress do about the crisis? While there is a case for raising the liabilities that auditors and analysts face, I am fully aware that many are skeptical of private enforcement of law through class and derivative actions. Essentially, this asks a third watchdog—the plaintiff's attorney—to monitor the failings of the first two (auditors and analysts), and plaintiff's attorneys may have their own misincentives. Also, it may still be too early to ask Congress to revisit the Private Securities Litigation Reform Act of 1995 (the PSLRA). Thus, both in my December appearance before the Senate Commerce Committee and again today, I urge Congress to give fuller consideration to public enforcement through the creation or strengthening of self-regulatory organizations (SRO's). An SRO already exists with jurisdiction over securities analysts (for example, the NASD), but one needs to be created from whole cloth in the case of auditors. Thus, my comments will focus first on the creation of a new SRO for auditors and then how to strengthen the oversight of analysts.

An SRO for Auditors: Some Suggested Standards

The governance of accounting is today fragmented and indeed Balkanized among (1) State boards of accountancy, (2) private bodies, of which there are essentially seven, and (3) the SEC, which has broad antifraud jurisdiction, but less certain authority under Rule 102(e) of its Rules of Practice.[4] Disciplinary authority is particularly divided within the profession. The Quality Control Inquiry Committee (QCIC) of the SEC Practice Section of the American Institute of Certified Public Accountants (AICPA) is delegated responsibility to investigate alleged audit failures involving SEC clients arising from litigation or regulatory investigations, but it is charged only with determining if there are deficiencies in the auditing firm's system of quality control. The Professional Ethics Executive Committee (PEEC) of the AICPA is suppose to take individual cases on referral from the QCIC, but as a matter of "fairness" PEEC will automatically defer, at the subject firm's request, any investigation until all litigation or regulatory proceedings have been completed. In short, the investor's interest in purging corrupt or fraudulent auditors from the profession is subordinated to the firm's interest in settling litigation cheap, uninfluenced by any possible findings of ethical lapses.

Little in this system merits retention. Legislation is necessary to create a body that would have at least the same powers, duties and obligations as the NASD. In truth, however, the legislation that created the NASD in 1938 (the Maloney Act) is not an ideal model, given its general lack of specific guidance. Rather, model legislation should have the following elements:

1. *Rulemaking Power.* The SRO should be specifically authorized to (1) address and prohibit conflicts of interest and other deficiencies that might jeopardize either auditor independence or the public's confidence in the accuracy and reliability of published financial statements, and (2) establish mandatory procedures, including procedures for the retention of accountants by publicly-held companies and for the interaction and relationship between the accountants and audit committees. This is a broad standard—and deliberately so. It could authorize the SRO to require that auditors be retained and/or fired by the audit committee and not by the company's management. In addition, the SRO should be authorized to affirmatively mandate

[3] Id. 715 of these restatements involved Nasdaq listed companies; 228 involved New York Stock Exchange companies; the rest were listed either on the American Stock Exchange or were traded in the over-the-counter market. Premature revenue recognition was found to be the leading cause of restatements.

[4] 17 CFR § 201.102. The SEC's authority under Rule 102(e) was clouded by the D.C. Circuit's decision in *Checkosky* v. *SEC,* 139 F.3d 221 (D.C. Cir. 1998) (dismissing Rule 102(e) proceeding against two accountants of a "Big 5" firm). The SEC revised Rule 102 in late 1998 in response to this decision (see Securities Act. Rel. No. 7593 (October 18, 1998), but its authority in this area is still subject to some doubt that Congress may wish to remove or clarify.

the adoption and use of new or improved quality control systems, as they from time to time become accepted.

2. *Mandatory Membership.* All outside auditors preparing or certifying the financial statements of publicly-held companies or of companies conducting registered public offerings would be required to be members in good standing, and suspension or ouster from the SRO would render an auditor unable to certify the financial statements of such companies.

3. *SEC Supervision.* SEC approval of the initial registration of such an SRO and of all amendments to its rules would be mandated, just as in the case of the NASD. The SEC would also have authority to amend the SRO's rules in compliance with a statutory "public interest" standard. Finally, the SEC should have authority to sanction, fine, or suspend the SRO and to remove or suspend its officers or directors for cause.

4. *Enforcement Powers.* The SRO should have the same authority to impose financial penalties or to suspend or disbar an auditor from membership, or to suspend, disbar, fine, or censure any associated professional. Such fines and penalties should not require proof of fraud, but only a demonstration of negligent or unethical conduct. Subpoena authority should also be conferred, and a failure to cooperate or to provide evidence should be grounds for discipline or dismissal.

5. *Duties of Supervisory Personnel.* A common response of organizations caught in a scandal or a criminal transaction is to blame everything on a "rogue" employee. Yet, such "rogues" are often responding to winks and nods from above (real or perceived) or to an organizational culture that encourages risk-taking (Enron is again symptomatic). The Federal securities laws impose duties on supervisory personnel in brokerage firms to monitor their employees, and a parallel standard should apply to supervisory personnel in auditing firms.

6. *Governance.* The SRO should have at least a supermajority (say, 66⅔ percent) of "public" members, who are not present or recently past employees or associated persons of the auditing industry.

7. *Prompt Enforcement.* The practice now followed by PEEC of deferring all disciplinary investigations until civil litigation and regulatory investigations have been resolved is self-defeating and unacceptable. It might, however, be possible to render the findings and disciplinary measures taken by the SRO inadmissible in private civil litigation.

Securities Analysts

What Do We Know About Analyst Objectivity

A number of studies have sought to assess the impact of conflicts of interest upon the objectivity of securities analyst recommendations. Additional evidence was also recently collected at hearings held in June 2001 by the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee. This data is probably more germane, and merits greater reliance, than the well-known statistic that an alleged 100:1 ratio exists between the "buy" recommendations and "sell" recommendations made by securities analysts. Although the actual ratio may be somewhat less extreme than 100:1,[5] the real problem with this statistic is that it is not necessarily the product of conflicts of interest. That is, analysts employed by brokerage firms (as all "sell-side" analysts are) have a natural incentive to encourage purchase or sale transactions. For this purpose, "buy" recommendations are more useful than "sell" recommendation, because all clients can buy a stock, but only existing holders can sell as a practical matter.

Other data better illustrates the impact of conflicts of interest on analysts. Among the most salient findings from recent research are the following:

1. *Conflict of Interests.* Several studies find that "independent" analysts (for example, analysts not associated with the underwriter for a particular issuer) behave differently than analysts who are so associated with the issuer's underwriter. For example, Roni Michaely and Kent Womack find that the long-run performance of firms recommended by analysts who are associated with an underwriter was significantly worse than the performance of firms recommended by independent securities analysts.[6] They further find that stock prices of firms recommended by analysts associated with lead underwriters fall on average in the 30 days before a recom-

[5] A December 2000 Thomson Financial Survey reported that 71 percent of all analyst recommendations were "buys" and only 2.1 percent were sells. Apparently, only 1 percent of 28,000 recommendations issued by analysts during late 1999 and most of 2000 were "sells." This study also finds that the overall "buy" to "sell" ratio shifted from 6:1 in the early 1990's to 100:1 by sometime in 2000. Of course, this shift also coincided with the Nasdaq bull market of the 1990's.

[6] See R. Michaely and K. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations,* 12 Review of Financial Studies 653 (1999).

mendation is issued, while the stock prices of firms recommended by analysts not so associated with underwriters rose on average over the same period. Finally, the mean long-run performance of buy recommendations made by analysts on nonclients is more positive than the performance of recommendations made on clients—at least for 12 out of 14 brokerage firms.

Still another study by CFO Magazine reports that analysts who work for full-service investment banking firms have 6 percent higher earnings forecasts and close to 25 percent more buy recommendations than do analysts at firms without such ties.[7] Similarly, using a sample of 2,400 seasoned equity offerings between 1989 and 1994, Lin and McNichols find that lead and co-underwriter analysts' growth forecasts and particularly their recommendations are significantly more favorable than those made by unaffiliated analysts.[8]

2. *Pressure and Retaliation.* In self-reporting studies, securities analysts report that they are frequently pressured to make positive buy recommendations or at least to temper negative opinions.[9] Sixty-one percent of analysts responding to one survey reported personal experience with threats of retaliation from issuer management.[10] Similarly, former Acting SEC Chairman Laura Unger noted in a recent speech that a survey of 300 chief financial officers found that 20 percent of surveyed CFO's acknowledged withholding business from brokerage firms whose analysts issued unfavorable research.[11] This is a phenomenon that is almost certain to be underreported.

This data should not be overread. It does not prove that securities research or analyst recommendations are valueness or hopelessly biased, but it does tend to confirm what one would intuitively expect: Namely, conflicts of interest count, and conflicted analysts behave differently than unaffiliated or "independent" analysts.

The Regulatory Response

In light of public criticism regarding securities analysts and their conflicts of interest, the National Association of Securities Dealers (NASD) proposed Rule 2711 (Research Analysts and Research Reports) in early February 2002.[12] Proposed Rule 2711 is lengthy, complex and has not yet been adopted. Nonetheless, because its adoption in some form seems likely, a brief analysis of its contents seems useful as an introduction to what further steps Congress should consider.

Basically, Rule 2711 does seven important things:

(1) It places restrictions on investment banking department's relationship with the "research" or securities analyst division of an integrated broker-dealer firms.

(2) It restricts the prepublication review of analyst research reports by the subject company and investment banking personnel.

(3) It prohibits bonus or salary compensation to a research analyst based upon a specific investment banking services transaction.

(4) It prohibits broker-dealers from promising favorable research or ratings as consideration or an inducement for the receipt of business or compensation.

(5) It extends the "quiet period" during which the broker-dealer may not publish research reports regarding a company in an IPO for which the firm is acting as a manager or co-manager for 40 calendar days from the date of the offering.

(6) It restricts analysts ability to acquire securities from a company prior to an IPO or to purchase or to sell for a defined period before or after the publication of research report or a change in a rating or price target.

(7) It requires extensive disclosure by an analyst of certain stock holdings or compensation or other conflict of interest relationships.

All of these prohibitions are subject to substantial exceptions and/or qualifications, and it is debatable whether some can be effectively monitored. Only time and experience with proposed Rule 2711 can tell us whether its exceptions will overwhelm the rule. Nonetheless, Rule 2711 represents a serious and commendable effort to police the conflicts of interest that exist within broker-dealer firms that both underwrite securities and provide securities research and recommendations. In this light, the most important question is: What else can or should Congress do? Are these topics or areas that Rule 2711 has not addressed that Congress should address? These are considered below:

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7 See S. Barr, "What Chinese Wall," CFO Magazine, March 1, 2000.

8 H. Lin and M. McNichols, *Underwriting Relationships and Analysts' Earnings Forecasts and Investment Recommendations,* 25 J. of Accounting and Economics 101 (1997).

9 J. Cote, *Analyst Credibility: The Investor's Perspective,* 12 J. of Managerial Issues 351 (Fall 2000).

10 D. Galant, "The Hazards of Negative Research Reports," Institutional Investor, July 1990.

11 Laura Unger, "How Can Analysts Maintain Their Independence?" Speech at Northwestern Law School (April 19, 2001).

12 See File No. SR–NASD–2002–21 (February 8, 2002).

Congressional Options

The overriding policy question is whether conflicts of interest relating to securities research should be prohibited or only policed. As I will suggest below, this question is not easily answered, because there are costs and imperfections with both options:

1. *Radical Reform: Divorce Investment Banking From Securities Research.* Congress could do what it essentially did a half century ago in the Glass–Steagall Act:[13] namely, prohibit investment banking firms that underwrite securities from engaging in a specified activity (here, providing securities research to all, or at least certain, customers). Arguably, this is what Congress and the SEC have already proposed to do with respect to the accounting profession: For example, separate the auditing and consulting roles performed by accountants. Here the conflict might be thought to be even more serious because the empirical evidence does suggest that the advice given by conflicted analysts is different from the advice given by independent analysts.

But this divestiture remedy is here even more problematic than in the case of the original Glass–Steagall Act. Put simply, securities research is not a self-sufficient line of business that exist on a freestanding basis. To be sure, there are a limited number of "independent" securities research boutiques (Sanford C. Bernstein & Co. is probably the best known and the most often cited example) that do not do the underwriting, but still survive very well. Yet this is a niche market, catering to institutional investors. Since May 1, 1975 (Mayday) when the old system of fixed commissions was ended and brokerage commissions became competitively determined, commission have shrunk to a razor-thin margin that will not support the costs of securities research. Instead, securities research (for example, the salaries and expenses of securities research) is essentially subsidized by the investment banking division of the integrated broker-dealer firm. The problematic result is at the same time to subsidize and arguably distort securities research.

This point distinguishes the securities analysts from the accountant. That is, if the auditor is prohibited from consulting for the client, both the auditing and the consulting function will survive. But, in particular because the costs of securities research cannot be easily passed on to the retail customer, a Glass–Steagall divorce might imply that the number of securities analysts would shrink by a substantial fraction.[14] A cynic might respond: Why seek to maximize biased research? Yet if the number of analysts were to fall by, hypothetically, one half, market efficiency might well suffer, and many smaller firms simply would not be regularly covered by any analyst. Hence, the divestiture approach may entail costs and risks that cannot be reliably estimated.

2. *Piecemeal Reform: Policing Conflicts.* Proposed Rule 2711 represents an approach of trying to police conflicts and prevent egregious abuse. The practical ability of regulators to do this effectively is always open to question. For example, although proposed Rule 2711 generally prohibits investment banking officials from reviewing research reports prior to publication, it does permit a limited review "to verify the factual accuracy of information in the research report" (see Rule 2711(b)(3)). It is easy to imagine veiled or stylized communications that signal that the investment banking division is displeased and will reduce the analyst's compensation at the next regular salary review. Such signals, even if they consist only of arched eyebrows, are effectively impossible to prohibit. Still, at the margin, intelligent regulation may curtail the more obvious forms of abuse. Although proposed Rule 2711 addresses many topics, it does not address every topic. Some other topics that may merit attention are discussed below, but they are discussed in the context of suggesting that Congress might give the NASD general policy instructions and ask it to fine tune more specific rules that address these goals:

1. *An Anti-Retaliation Rule.* According to one survey,[15] 61 percent of all analysts have experienced retaliation—threats of dismissal, salary reduction, etc.—as the result of negative research reports. Clearly, negative research reports (and ratings reductions) are hazardous to an analyst's career. Congress could either adopt, or instruct the NASD to adopt, an anti-retaliation rule: No analyst should be fired, demoted or economically penalized for issuing a negative report, downgrading a rating, or reducing an earnings, price, or similar target. Of course, this rule would not bar staff reductions or reduced bonuses based on economic downturns or individualized performance assessments. Thus, given the obvious possibility that the firm could re-

[13] See the Glass–Steagall Act of 1933, 12 U.S.C. § 36 et. seq. (separating commercial and investment banking).

[14] I recognize that the number of "buy side" analysts employed by institutional investors might correspondingly increase, but not, I think, to a fully compensating degree. Moreover, "buy side" analysts do not publish their research, thus implying increased informational asymmetrics in the market.

[15] See Galant, supra note 10, and Cote, supra note 9.

duce an analyst's compensation in retaliation for a negative report, but describe its action as based on an adverse performance review of the individual, how can this rule be made enforceable? The best answer may be NASD arbitration. That is, an employee who felt that he or she had been wrongfully terminated or that his or her salary had been reduced in retaliation for a negative research report could use the already existing system of NASD employee arbitration to attempt to reverse the decision. Congress could also establish the burden of proof in such litigation and place it on the firm, rather than the employee/analyst. Further, the Congress could entitle the employee to some form of treble damages or other punitive award to make this form of litigation viable. Finally, the Congress could mandate an NASD penalty if retaliation were found, either by an NASD arbitration panel or in an NASD disciplinary proceeding.

2. *A No-Selling Rule.* If we wish the analyst to be a more neutral and objective umpire, one logical step might be to preclude the analyst from direct involvement in selling activities. For example, it is today standard for the "star" analyst to participate in "road shows" managed by the lead underwriters, presenting its highly favorable evaluation of the issuer and even meeting on a one-to-one basis with important institutional investors. Such sales activity seems inconsistent with the much-cited "Chinese Wall" between investment banking and investment research.

Yet from the investment banking side's perspective, such participation in sales activity in what makes the analyst most valuable to the investment banker and what justifies multimillion dollar salaries to analysts. Restrict such activities, they would argue, and compensation to analysts may decline. Of course, a decline in salaries for the super-stars does not imply a reduction in overall coverage or greater market inefficiency.

Although a "no-selling" rule would do much to restore the objectivity of the analyst's role, one counter-consideration is that the audience at the road show is today limited to institutions and high net worth individuals. Hence, there is less danger that the analyst will overreach unsophisticated retail investors. For all these reasons, this is an area where a more nuanced rule could be drafted by the NASD at the direction of Congress that would be preferable to a legislative command.

3. *Prohibiting the "Booster Shot."* Firms contemplating an IPO increasingly seek to hire as lead underwriter the firm that employs the star analyst in their field. The issuer's motivation is fueled in large part by the fact that the issuer's management almost invariably is restricted from selling its own stock (by contractual agreement with the underwriters) until the expiration of a lock-up period that typically extends 6 months from the date of the offering. The purpose of the lock-up agreement is to assure investors that management and the controlling shareholders are not "bailing out" of the firm by means of the IPO. But as a result, the critical date (and market price) for the firm's insiders is not the date of the IPO (or the market value at the conclusion of the IPO), but rather the expiration date of the lock-up agreement 6 months later (and the market value of the stock on that date). From the perspective of the issuer's management, the role of the analyst is to "maintain a buzz" about the stock and create a price momentum that peaks just before the lock-up's expiration.[16] To do this, the analyst may issue a favorable research report just before the lock-up's expiration (a so-called "booster shot" in the vernacular). To the extent that favorable ratings issued at this point seem particularly conflicted and suspect, an NASD rule might forbid analysts associated with underwriters from issuing research reports for a reasonable period (say, 30 days) both before and after the lock-up expiration date. Proposed Rule 2711 stops well short of this and only extends the "quiet period" so that it now would preclude research reports for this first 40 days after an IPO. Such a limited rule in no way interferes with the dubious tactic of "booster shots."

4. *Summary:* The most logical and less overbroad route for Congress to take with regard to securities analysts and their conflicts is to pass legislation giving the NASD more specific guidance and instructions about the goals that they should pursue and then instruct the NASD to conduct the necessary rulemaking in order to fine tune this approach. NASD penalties might also properly be raised. This approach spares Congress from having to adopt a detailed code of procedure, avoids inflexibility and rigid legislative rules, and relies on the expertise of the SEC and the NASD, as paradigms of sophisticated administrative agencies.

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[16] This description of the analyst's role (and of the underwriter's interest in attracting "star" analysts) essentially summarizes the description given by three professors of financial economics, Rajesh Aggarwal, Laurie Krigman, and Kent Womack, in their recent paper, Aggarwal, Krigman, and Womack, *Strategic IPO Underpricing, Information Momentum, and Lockup Expiration Selling* (April 2001) (available on SSRN).

ASAP

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HEADLINE: Quantitative Measures Of the QUALITY of Financial Reporting; Statistical Data Included

BYLINE: Moriarty, George B.; Livingston, Phillip B.

BODY:

High-quality financial reporting is a cornerstone of the United States capital markets. In fact most observers agree that the U.S. enjoys the greatest system of raising and allocating capital in the world. Both in terms of the system's cost efficiency and returns to shareholders, our markets are unmatched in history.

Over the last 20 years, equity returns to shareholders have averaged 15.7 percent per year. The total value of equity invested in U.S. stock markets grew to $16.09 trillion in 2000, from $1.45 trillion in 1980. In the last five years alone, the value of the U.S. equity markets has increased by $7.14 trillion.

These gains have come despite increasing criticism over the quality of financial reporting during the past five years, often after a specific financial reporting failure becomes known and receives wide and dramatic media coverage. While the individual cases are important to study, the systemic implications and calls for regulation have been imputed without any accompanying context as to the depth of the problem or the effect of restatements on market value.

Recognizing the need to measure and quantify the problem, the FEI Research Foundation partnered with Min Wu, a Ph.D candidate at New York University's Stern School of Business, on a project entitled "Quantitative Measures of the Quality of Financial Reporting." The goal of the project was to identify quantifiable metrics that can track the absolute and relative quality of financial reporting over time.

This research produced two measurable metrics for the years 1977 to 2000:

* The number of announced financial reporting restatements.

* Market value losses associated with restatements as a percentage of the total market value of equity securities.

Methodology

To measure the number of restatements, Wu searched the Dow Jones Interactive and Lexis-Nexis information services, using keyword searches on variations of the word "restatement." She reviewed all results from each case before it was added to the database. Cases stemmed from irregularities or errors that led the company to restate voluntarily or comply with an external auditor's findings, as well as restatements forced by the Securities and Exchange Commission. She excluded instances of accounting methodology changes, stock splits, dividends, inflation accounting and discontinued operations.

Wu then constructed the database, extracting the following data from the restatements that met the criteria.

* Company identifiers such as stock symbol, SIC code and CUSIP

* General facts of the restatement: date announced, upward or downward earnings revision, amount, share price at close one day before and one day after

* Basis: voluntary, SEC enforced or auditor recommended

* Type of filing restated -- 10-Q or 10-K, or both

* Reason for the restatement

To determine the market value losses associated with each restatement, the study used the change in share price from one day before and one day after the restatement announcement.

Quantifying the losses presented several challenges. Some thought was given to extending the window as much as one month prior to and following the restatement. However, that posed a risk that larger market effects would skew the results. Thus, the three-day window seemed more likely to present the effect of the restatement with as little accompanying noise as possible.

Two cases, Sunbeam in 1998 and Yahoo! in 1999, illustrate the difficulty in gauging the impact of restatements. Sunbeam was one of the major cases that brought increased scrutiny to the restatements issue. However, Sunbeam's troubles became known months before the company publicly restated its earnings. In the months before the announcement, the company's market value decreased substantially. As a result, the $31.5 million market value loss within the three-day window around the date of the restatement doesn't appear significant.

At the other end of the spectrum, the $4.6 billion market value loss associated with Yahoo!'s 1999 restatement was the second largest market value loss for that year. That restatement was associated with the revision of an in-process research and development write-off. As will be discussed later, such restatements generally have little impact on a company's market value. But, concurrent with Yahoo's announcement, Brazil devalued its currency, and all the major indexes plummeted on the day after the restatement. So, in spite of the shortened window, outside forces moved the stock price and are so reflected in the research database.

Key Observations

From 1977 to 2000, there were 1,080 earnings restatements. The number of cases were aggregated by year and compared to the number of public companies in each year. The number of restatements averaged just 0.51 percent of all public companies from 1985 to 2000, and just 0.67 percent from 1995 to 2000.

However, there was a significant increase in the number of restatements in 1998. After averaging 49 restatements per year from 1990 to 1997, restatements increased to 91 in 1998, 150 in 1999 and 156 in 2000.

The data on the exchanges where restating companies trade and market capitalization show that smaller companies tend to restate more often than larger ones. Nasdaq-listed companies accounted for 715 of the 1,080 restatements; New York Stock Exchange companies for 228; and the American Stock Exchange, OTC and Pink Sheets, 137 cases. The percentage of restatements annually follows these ratios very closely.

Breaking out the restatements from 1995 to 2000 by market capitalization follows this trend: 389, or 62 percent, of the 631 restatements came from companies with market values of less than $500 million, while 91, or fourteen percent, of the restatements came from companies with more than $1 billion in market cap.

Why Are Companies Restating?

The underlying reason for each restatement was organized into one of 10 groups: revenue, cost, revenue and cost, loan loss, acquisition, inprocess research and development (IPR&D), reclassification, bookkeeping errors, others and

unknown. Revenue recognition issues caused 33 percent of restatements. Cost problems, with inventory valuation as the leading source, caused 28 percent.

Restatements due to revenue recognition issues make up the largest portion of the database, providing 360 cases. The following were common themes for revenue restatements:

* Sales contingencies not disclosed to accounting or management

* Sales booked before delivery completed

* Significant rights of return existed

* Software revenue recognized before underlying services were performed

* False sales agreements and documentation

* Bill-and-hold sales not deferred

Cost and expense-based restatements ran a close second, with 305 cases. Surprisingly, the common errors in these cases stem primarily from the fundamental aspects of inventory valuation, including improper overhead absorption, obsolescence and valuation.

In-process research and development emerged as an issue in 1998, when the SEC addressed how firms accounted for in-process R&D in mergers and acquisitions. Based on what the SEC perceived to be overly aggressive IPR&D write-offs, the commission pursued and evaluated cases very aggressively in late 1998 and throughout 1999.

This resulted in 57 restatements in 1999 and 67 in total since 1998. By and large, these restatements had minimal effect on the companies' market value. By 2000, this issue seemed to have been absorbed into business practices, as there was just one IPR&D restatement for the year. Indeed, because the effects of IPR&D were so localized in 1999 and the market value effect so minimal, the bulk of the FEI Research Foundation analysis excluded those cases.

The number of cases enforced by the SEC for any reason averaged eight per year from 1990 to 1997. However, that number rose to 17 in 1998 and 21 in 2000. There were fully 75 SEC enforced restatements in 1999, but 48 were IPR&D cases. Identifying cases of SEC enforcement is an inexact science, because companies are not required to disclose this information.

Market Value Changes

Cases in which restatement led to a market value loss were aggregated by year. In measuring the total losses by year, restatements that led to a market value gain were excluded. The average annual market value loss from 1993 to 1997 was $1.3 billion, versus an average total market cap of $7.7 trillion. Thus, losses during this period averaged less than one-tenth of one percent of total market value. Total equity value was defined as the value of all companies listed on the NYSE, Nasdaq and American Stock Exchange.

In 1998, companies that restated earnings suffered market value losses of $17.7 billion, or 0.13 percent of the $13.61 trillion equity value of the entire market, Restatements in 1999 led to losses of $24.2 billion, or 0.14 percent of the $17.64 trillion market. Even in 2000, a year that saw $31.2 billion in market value losses due to restatements and $1.5 trillion shaved off the public market cap, restatement losses represented only 0.19 percent of total market value.

Restatements that led to market value losses of more than $100,000 occurred 69 times in 1998, 116 times in 1999 and 66 times in 2000. On average, these events affected less than 1 percent (0.7 percent) of all public companies from 1995 to 2000, and the cases show that companies restating due to revenue recognition errors suffered the highest losses.

From a dollar value standpoint, it is clear from the data that a small number of cases are responsible for the bulk of the lost value. The 10 largest annual market value losses for the years 1998 to 2000 account for more than 80 percent of the

losses in each of those years, and in 2000, the 10 largest cases accounted for $29.7 billion of the $31.2 billion total losses, a whopping 95 percent.

Excluding IPR&D cases, there were 394 restatements from 1998 to 2000, which caused a market value loss of $64.9 billion. The top eight market value losses -- MicroStrategies, Cendant, McKesson, Lucent, Legato Systems, Raytheon, Texas Instruments and Boston Scientific -- represented $50.2 billion, or 77 percent, of the total losses.

What Happened in 1998?

Despite the low overall rate of restatements and the minimal losses associated with them, the number of restatements increased noticeably in the last three years of this study, which raises the obvious question, Why? Although certain constituencies might answer differently, metrics developed by the research produce two broad reasons:

* A business environment that places increasing pressure on companies to meet performance goals.

* The earnings management initiative started by the SEC in 1998.

The dearest start date for the more aggressive stance on earnings management at the SEC was the September 1998 speech by then-Chairman Arthur Levitt. Its impact was considerable: 397 restatements, or 36 percent of all restatements between 1977 and 2000, occurred after that speech.

Today's corporate environment is driven by increasing shareholder activism, particularly regarding stock price performance on behalf of the shareholders. Large public pension funds such as CalPERS and TIAACREF have become closely organized in pressuring management teams and boards to deliver returns or get out. Furthermore, boards of directors, increasingly made up of independent outsiders, have become much more aggressive in removing senior officers when performance measures aren't met.

Overall, corporations have responded favorably to these heightened expectations and pressures. The result has often been spectacular results for shareholders, but some have clearly come at a cost. Pressure to deliver the numbers rose during the period leading up to the increase in restatements. While the gains are high, and total market value has increased more than $4.7 trillion since 1997, the cost to shareholders from restatements has been $74.3 billion, or 1.6 percent of the growth. On balance, companies and shareholders have plainly benefited from successfully managed businesses.

Conclusions

The study indicates that the overall quality of financial reporting is high.

* Market value losses associated with restatements are also small, as well as sharply focused.

* In the context of all publicly traded companies, the rate of restatements is very small.

* Revenue accounting is the largest reason for restatements.

* The measures developed through this study indicate that a systemic and environmental change has taken place over the last three years.

Thoughts for the Future

The FEI Research Foundation will update this data on a periodic basis. Tracking the number of restatements is an indicator of financial reporting quality that can be used to assert the need for systemic changes. Further, as discussed in the accompanying box, it isn't today's complex business transactions or the pace of change that creates restatements. Most often, it is straightforward revenue accounting. Industry, the professional associations and the regulators should look for opportunities to provide education in this area.

George B. Moriarty is a senior editor with FEI's Research Foundation. Philip B. Livingston is President and CEO of FEI.

Percentage of Total Reinstatement Losses To Total Value of Public

Companies

* 1990 0.021%

* 1991 0.009

* 1992 0.032

* 1993 0.004

* 1994 0.022

* 1995 0.016

* 1996 0.032

* 1997 0.011

* 1998 0.129

* 1999 0.137

* 2000 0.194

Restatement losses represent a negligible percentage of the total value

of public companies.

[Graph omitted]

[Graph omitted]

Revenue Recognition Leads Problems

Revenue recognition emerged as the leading reason for restatements in the research performed for Quantitative Measures of the Quality of Financial Reporting, accounting for one in every three restatements.

That alone would be cause for alarm, but further investigation shows that since 1995, restatements due to revenue recognition have increased every year, growing to 68 in 2000 from 15 in 1995. The issuance of SEC Staff Accounting Bulletin 101 on revenue recognition in December 1999 accounts for some of the growth in 2000, which saw 20 more revenue recognition restatements than in 1999.

The larger effect of these restatements also appears in market value losses. In 2000, for instance, eight of the 10 largest losses were due to revenue recognition, including the two biggest cases, MicroStrategies ($11.9 billion) and Lucent ($10.9 billion). In fact, the largest loss in each of the past three years has been assigned to revenue accounting problems -- MicroStrategies, McKesson in 1999 ($8.8 billion) and Cendant in 1998 ($11.4 billion).

A wide-ranging education initiative should serve all parties involved in financial reporting, beginning with SAB 101. Reporting companies' challenges are represented in MicroStrategies' announcement at the time of its restatement that its problems stemmed from the complexity of accounting rules.

Implementation of SAB 101 underscores the challenge of clarifying rules on revenue recognition. The third step in the series of revenue recognition bulletins that then SEC chairman Arthur Levitt promised in his 1998 speech on earnings management, the SAB intended to provide guidance on when corporations should recognize revenue.

However, the intricacies involved in the process created such consternation that implementation was delayed twice, and companies continue to struggle with revenue recognition. In fact, the effort to understand and implement the bulletin has led to the launch of SAB101.org, an online educational resource devoted to the initiative.

Controversy over revenue recognition continues, however. At press time the FASB announced it would require consumer product companies to deduct from their revenue the amount they pay in sloting fees and restate financial statements as far back as 10 years. Slotting fees are up-front payments to retailers to secure shelf space for products.

IAC-CREATE-DATE: August 14, 2001

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United States General Accounting Office

GAO

Report to Congressional Requesters

March 2002

SEC OPERATIONS

Increased Workload Creates Challenges

GAO

Accountability * Integrity * Reliability

GAO-02-302

United States General Accounting Office

GAO
Accountability ★ Integrity ★ Reliability

Highlights

SEC OPERATIONS
Increased Workload Creates Challenges

Highlights of GAO-02-302, a report to Paul S. Sarbanes, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate; Christopher J. Dodd, Chairman, Subcommittee of Securities and Investment; and Jon S. Corzine, Member, Committee on Banking, Housing and Urban Affairs, U.S. Senate.

Why GAO Did This Study

In the past decade, securities markets have undergone tremendous growth and innovation. Responding to concern that the Securities and Exchange Commission's (SEC) workload has outgrown its resources and impaired SEC's ability to fulfill its mission, GAO undertook a study to (1) determine how the securities markets have changed, (2) identify whether SEC's resource levels have affected its ability to regulate and oversee the markets, and (3) identify any other factors that may affect SEC's ability to fulfill its mission.

What GAO Recommends

GAO recommends that SEC explore short- and long-term recommendations to address its current challenges. In the short-term, SEC should ensure that it explores ways to use all of its available resources to address its recruiting and retention problems.

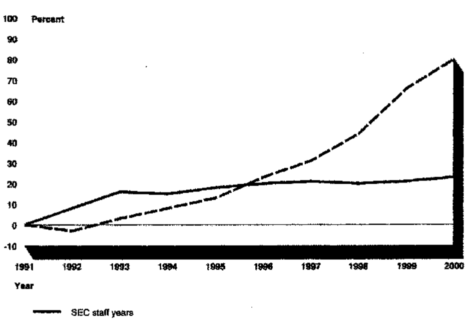
In the long-term, we recommend that SEC broaden its strategic planning process to determine its regulatory priorities and the resources needed to fulfill its mission, including identifying the skills needed.

SEC, generally, agreed with the report's findings, conclusions, and recommendations.

What GAO Found

U. S. securities markets have grown tremendously and become more complex and international. As a result, SEC's workload has increased in volume and complexity over the past decade. As illustrated below, around 1996, SEC's workload (e.g., filings, applications, and examinations) started to increase at a much higher rate than SEC staff years devoted to this workload. Although industry officials said that they respect SEC as a regulator, they said that SEC's limited staff resources have resulted in substantial delays in SEC regulatory and oversight processes, which hampers competition and reduces market efficiencies. In addition, they said information technology issues need additional funding, and SEC needs more expertise to keep pace with rapidly changing financial markets. Finally, the officials said that SEC's reliance on a small number of seasoned staff to do the majority of the routine work does not allow those staff to adequately deal with emerging issues.

Although most officials said that SEC's resource limitations create challenges for SEC, they identified other contributing factors. First, SEC's high staff turnover has resulted in it having a more inexperienced staff, which contributes to the identified delays in SEC's regulatory processes. Second, existing securities laws, which require SEC approval of most market innovations and new products, can contribute to regulatory bottlenecks. Finally, SEC's budget and strategic planning processes could be better linked to help SEC identify the types and amounts of additional resources needed to fulfill its mission.



Source: GAO analysis of SEC data.

This is a test for developing highlights for a GAO report. The full report, including GAO's objectives, scope, methodology, and analysis is available at *www.gao.gov/cgi-bin/getrpt?GAO-02-302*. For additional information about the report, contact Richard J. Hillman (202-512-8678). To provide comments on this test highlights, contact Keith Fultz (202-512-3200) or email *HighlightsTest@gao.gov*.

Abbreviations

ARP	Automation Review Policy
ATS	alternative trading system
ECN	electronic communication network
EDGAR	Electronic Data Gathering Analysis and Retrieval
GLBA	Gramm-Leach-Bliley Act of 1999
GPRA	Government Performance and Results Act
IA	investment adviser
IARD	investment adviser registration depository
IC	investment company
IG	inspector general
IPO	initial public offering
OCIE	Office of Compliance Inspections and Examinations
OMB	Office of Management and Budget
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

March 5, 2002

The Honorable Paul S. Sarbanes
Chairman, Committee on Banking, Housing, and
Urban Affairs
United States Senate

The Honorable Christopher J. Dodd
Chairman, Subcommittee on Securities and Investment
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Jon S. Corzine
United States Senate

The securities markets have undergone tremendous change and innovation over the last decade, and the Securities and Exchange Commission (SEC) faces growing regulatory and oversight challenges to stay abreast of these advances. More recently, the sudden highly publicized collapse of Enron Corporation has increased the pressure on SEC to ensure that investors receive accurate and meaningful financial disclosure, an important part of SEC's mission to protect investors. In addition, technological advances have increased the complexity of securities markets and the range of products offered to the public. Moreover, technology has changed the way investors can buy and sell securities, for example through on-line brokerages, and how investors are solicited, given the increased access to information on the Internet. These changes and the internationalization of securities markets have presented SEC with increasing responsibilities in a dynamic regulatory environment. Also, legislative changes, such as the Gramm-Leach-Bliley Act of 1999 (GLBA), the Commodity Futures Modernization Act of 2000, and the USA PATRIOT Act of 2001, place added demands on SEC. Because more individuals and families are now invested in the markets, the role SEC plays has become even more important to the investing public.

You asked that GAO review whether SEC had sufficient resources to stay abreast of the changes in the markets. Our objectives were to (1) identify how securities markets have changed, (2) determine whether SEC's resource levels and workload have affected SEC's ability to regulate and oversee the markets, and (3) identify any other factors that may affect SEC's ability to fulfill its mission.

In addressing these objectives, we analyzed securities market and available SEC workload trend data. However, in certain instances, quantifiable data was not provided to us for workload measures, such as the length of review and approval processes conducted within SEC divisions. We met with various knowledgeable SEC and industry officials to obtain their views on whether these processes were affected by SEC's existing workload demands and resources levels. To obtain information on whether SEC's ability to regulate and oversee the markets has been affected by resource constraints, we interviewed current and past SEC officials, including division and office directors, regional office directors, budget officials, former commissioners, and academics. In addition, we interviewed numerous industry officials, including those from various exchanges, associations, investment companies, and broker-dealers. We also asked these parties about any other factors that might affect SEC's ability to fulfill its mission. We also reviewed relevant GAO and inspector general reports on SEC's oversight activities. Finally, we reviewed and evaluated SEC's strategic plan and Government Performance and Results Act (GPRA) reports.

Background

SEC's primary mission is to protect investors and the integrity of the securities markets. SEC seeks to (1) promote full and fair disclosure, (2) prevent and suppress fraud, (3) supervise and regulate the securities markets, and (4) regulate and oversee investment companies, investment advisers, and public utility holding companies. It works to fulfill this mission through various divisions and offices. In 2001, GAO issued a report that addressed many of the human capital challenges SEC faces.[1]

SEC Focuses on Disclosure, Oversight, and Enforcement

SEC fulfills its mission to protect investors and the integrity of securities markets through activities focused on disclosure, oversight, and enforcement. The laws and rules governing the securities industry are based on the concept that all investors, whether large institutions or private individuals, should have access to basic information about an investment prior to trading. To achieve this, the securities laws require public companies to register with SEC and to periodically make public

[1] U.S. General Accounting Office, *Securities and Exchange Commission: Human Capital Challenges Require Management Attention*, GAO-01-947 (Washington, D.C.: Sept. 17, 2001).

meaningful financial and other information for all investors to use to determine whether a company's securities are an appropriate investment.

SEC also oversees the activities of a variety of key market participants. In 2001, SEC was responsible for 9 exchanges, the over-the-counter market, approximately 70 alternative trading systems (ATSs),[2] 12 registered clearing agencies, about 8,000 registered broker-dealers employing over 700,000 registered representatives, almost 8,000 transfer agents,[3] over 5,000 investment companies and 7,400 registered investment advisers. In addition, over 14,000 companies that have issued securities filed annual reports with SEC. SEC's oversight includes rulemaking, surveilling the markets, interpreting laws and regulations, reviewing corporate filings, processing applications, conducting inspections and examinations, and determining compliance with federal securities laws. SEC is also responsible for regulating public utility holding companies.

Each year SEC brings hundreds of civil enforcement actions against individuals and companies that violate securities laws. Violations include insider trading, financial and accounting fraud, providing false or misleading information about securities and the companies that issue them, selling of securities without proper registration, and violating broker-dealer responsibility to treat customers fairly. An ongoing program to educate investors and ensure that their concerns are known throughout SEC supplements SEC's enforcement efforts.

SEC's Organizational Structure

As of September 30, 2001, SEC had 3,285 staff (or 2,936 full-time equivalent staff years) working in 4 divisions and 18 offices in Washington, D.C. and in 11 regional and district offices. Of these, approximately 39 percent were attorneys, 18 percent were accountants or financial analysts, and 6 percent were investigators or examiners. The remaining 37 percent were various other professional, technical, administrative, and clerical staff. See figure 1 for a description of SEC's major divisions and offices.

[2] An ATS is any entity that performs functions commonly performed by a stock exchange.

[3] Transfer agents are parties that maintain records of stock and bond owners.

Figure 1: SEC Divisions and Selected Offices

The Division of Corporation Finance oversees corporate disclosure of important information to the investing public. Public corporations are required to comply with regulations pertaining to disclosure that must be made when stock is initially sold and then on a continuing and periodic basis. This division routinely reviews the disclosure documents filed by public companies. It also provides public companies with assistance interpreting SEC's rules and recommends new rules for adoption.

The Division of Enforcement investigates possible violations of securities laws, recommends SEC action, when appropriate, either in a federal court or before an administrative law judge, and negotiates settlements on behalf of the SEC commissioners. While SEC has civil enforcement authority only, it works closely with various criminal law enforcement agencies such as the Department of Justice and U.S. Attorney General offices throughout the country to develop and bring criminal cases when the misconduct warrants more severe action.

The Division of Market Regulation establishes and maintains standards for fair, orderly, and efficient markets. It does this primarily by regulating the major securities market participants including broker-dealers, self-regulatory organizations (SROs), transfer agents, and securities information processors.

The Division of Investment Management oversees and regulates the investment management industry and administers the securities laws affecting investment companies, including mutual funds and investment advisers. In applying the federal securities laws to this industry, this division seeks to improve disclosure and minimize risk for investors without imposing undue costs on regulated entities. The division also administers the Public Utility Holding Company Act of 1935.

The Office of Compliance Inspections and Examinations administers SEC's nationwide examination and inspection program for registered SROs, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers. This office conducts inspections to promote compliance with the securities laws, to detect violations of the law, and to keep the SEC commissioners informed of developments in the regulated community.

The Office of Economic Analysis advises the SEC commissioners and SEC staff on the economic issues associated with SEC's regulatory and policy activities. This office analyzes the potential impacts and benefits of proposed regulations, conducts studies on specific rules, and engages in long-term research and policy planning.

The Office of the General Counsel is the chief legal officer of SEC. Primary duties of this office include representing SEC in certain civil, private, or appellate proceedings, preparing legislative material, and providing independent advice and assistance to the SEC commissioners, the divisions, and the offices.

The Office of Investor Education and Assistance serves individual investors, ensuring that their problems and concerns are known throughout SEC and considered when the agency takes action. Investor assistance specialists answer questions, analyze complaints, and seek informal resolutions.

The Office of Information Technology is responsible for supporting the SEC commissioners and SEC staff in all aspects of information technology. This office operates the Electronic Data Gathering Analysis and Retrieval (EDGAR) system, which electronically receives, processes, and disseminates more than 500,000 financial statements every year. This office also maintains SEC's Web site.

Other SEC offices: administrative law judges; administrative and personnel management; chief accountant; comptroller; equal employment opportunity; executive director; filings and information services; inspector general; international affairs; legislative affairs; public affairs, policy evaluation, and research; and the office of the secretary. SEC regional and district offices include field staff to conduct its enforcement, examination, and inspection functions.

Source: SEC.

2001 GAO Report Found SEC Faces Human Capital Challenges

In 2001, we issued a report, which discussed the human capital challenges SEC faces.[4] We surveyed current and former SEC attorneys, accountants, and examiners to determine why they had left or would consider leaving SEC. Overwhelmingly, compensation was cited as the primary reason for leaving. Respondents also identified other nonpay factors that had or would affect their decisions to leave, such as the lack of opportunities for advancement, the amount of uncompensated overtime, and the quality of administrative support.

To recruit, retain, and motivate employees, we found that SEC used various compensation-based programs, such as recruitment bonuses, retention allowances, and special pay rates, more actively than other government agencies. For example, in March 2001, SEC received OPM approval to update its special rates for attorneys, accountants, and examiners. These special pay rates are generally equivalent to a several-step increase in the basic government pay scale. Because staff cannot receive the special pay rate and a locality pay adjustment, SEC would have to request special pay adjustments annually to prevent the locality pay adjustments from eroding the benefit of the special pay.

We also found that while SEC also offers a number of work life programs, it has only recently increased its focus on providing greater flexibilities to its staff such as opportunities to work compressed work schedules. We also found that SEC management had made improvements to its recruitment program, which included additional training for recruiters and expanded on-campus recruiting and added a new human capital goal to its performance plan. However, more remains to be done in order for SEC to strategically align its core mission with its ability to recruit and retain qualified employees. We recommended that the chairman, SEC, periodically survey employees to measure job satisfaction, identify employee concerns, and analyze the effectiveness of the agency's programs to retain employees. We also recommended that the chairman, SEC, include a strategy for succession planning and a comprehensive, coordinated workforce planning effort in the agency's annual performance plan. Finally, we recommended that the chairman, SEC, identify ways to involve human capital leaders in decision making and establish a practice that requires management to continually ensure the effectiveness of SEC's human capital approaches in addressing employees' needs, including

[4] GAO-01-947.

working with the National Treasury Employees Union to expeditiously address the areas of dissatisfaction identified in our survey.[5]

Securities Markets Have Become Larger and More Complex

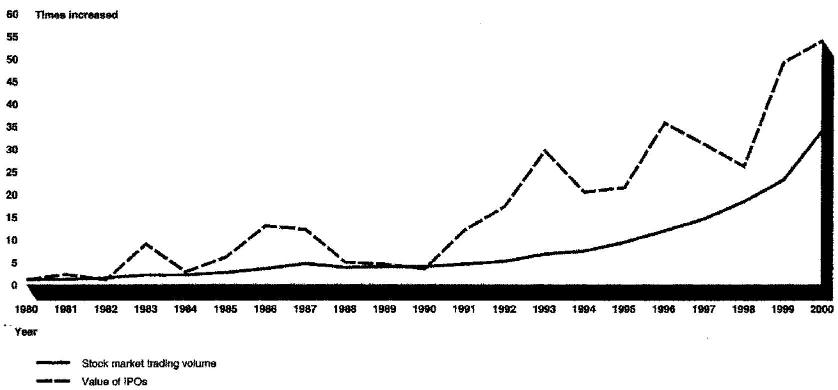
Over the last decade, securities markets have experienced unprecedented growth and change. Moreover, technology has fundamentally changed the way markets operate and how investors access markets. These changes have made the markets more complex. In addition to these market-driven changes, the markets have become more international, and legislative changes have resulted in a regulatory framework that requires increased coordination among financial regulators and requires that SEC regulate a greater range of products.

U.S. Capital Markets Have Grown Rapidly

Over recent decades, U.S. capital markets have experienced substantial growth, especially in the 1990s. As shown in figure 2, the volume of shares traded in U.S. stock markets in 2000 was over 30 times higher than the volume in 1980. Although many factors contributed to this unprecedented growth, it was in part spurred by technological advances and decreasing transaction costs, which made it easier and more affordable for investors to participate in the market. Figure 2 also shows that the value of initial public offerings (IPOs) of securities issued in 2000 was over 50 times the number of IPOs issued in 1980 as private companies took advantage of the strong economy and favorable market conditions and issued stock to raise capital.

[5] In July 2000, SEC employees voted to join the National Treasury Employees Union.

Figure 2: Number of Times Stock Market Trading Volume and the Value of IPOs Have Increased between 1980 and 2000

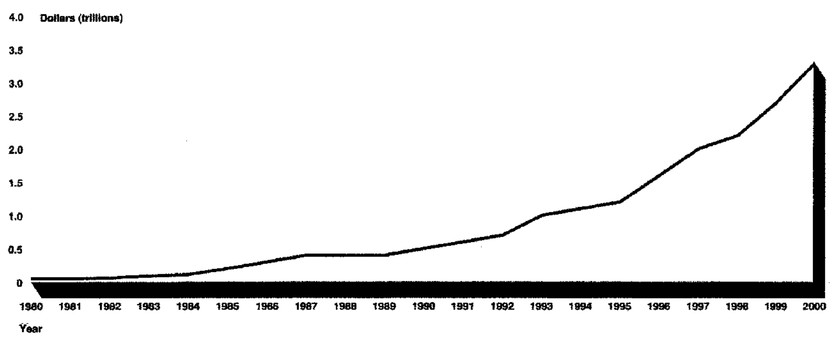


Source: GAO analysis of SEC data.

Likewise, in the 1990s many more individuals became investors by buying shares in mutual funds, further elevating the importance of SEC as a regulator. Figure 3 shows that the dollars that households had invested in mutual funds, excluding money market funds, grew from $46 billion in 1980 to $3.3 trillion in 2000. Moreover, as of December 2001, the total dollars invested[6] in mutual funds was almost $7 trillion, about twice the amount on deposit at commercial banks. This growth in amounts invested was due in part to higher stock values.

[6] Total dollars invested includes money market funds and funds owned by households; fiduciaries; and financial, business, and other organizations.

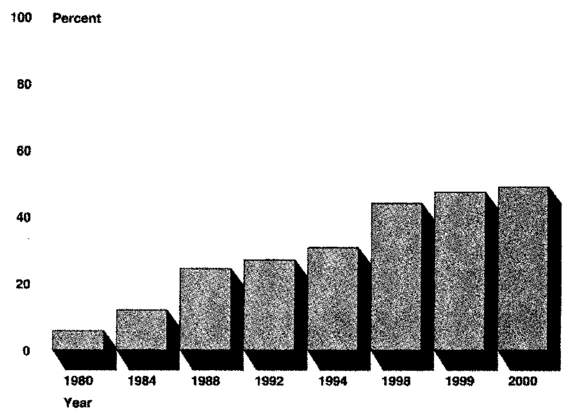
Figure 3: Growth in Dollars Households Invested in Funds, 1980-2000 (trillions of dollars)



Source: GAO analysis of SEC data.

Between 1980 and 2000, more households and individuals became investors in mutual funds and stocks. Figure 4 shows that the percent of U.S. households owning mutual funds also had increased to almost 50 percent of households by 2000. According to SEC, the number of households owning mutual funds in 2001 continued to increase with 52 percent of households owning funds. According to SEC, stock funds account for almost half of all mutual fund assets, and 75 percent of cash inflows to these funds come from retirement plans. Since 1990, the percent of U.S. retirement assets held in mutual funds has more than tripled. Moreover, according to New York Stock Exchange data, the number of individuals that owned shares of stocks increased 61 percent between 1989 and 1998.

Figure 4: Percent of U.S. Households Owning Mutual Funds, 1980-2000



Source: Investment Company Institute.

Securities Markets Have Become More Complex and International

Driven by technological advances, the securities markets have become more complex with an array of new products and market participants. Exchange-traded funds,[7] single-stock futures,[8] and on-line portfolios add to the products that SEC must oversee. Other technology-driven innovations such as ATSs, on-line brokerages, and day trading firms have also stretched SEC's regulatory capacity. For example, SEC regulates about 70 ATSs. Electronic communication networks (ECNs) ,[9] one type of ATS, account for about 30 percent of the daily share volume in Nasdaq

[7] An exchange-traded fund is type of investment company whose shares can be bought and sold on the secondary market, as well as from the investment company in large blocks of shares.

[8] A single-stock future is a contract to buy or sell a specific security at a particular price in a stipulated future month.

[9] An ECN is an electronic trading system that automatically matches buy and sell orders at specified prices. ECNs register with the SEC as broker-dealers.

securities. On-line brokerages, which were unknown a few years ago, are used by almost 12 million investors in making about 1.1 million trades per day. Likewise, investor protection concerns about day trading firms' activities resulted in greater regulatory activity in this area over the past few years.

New technology also has affected how the markets operate and how participants communicate. Stock exchanges and markets use complex electronic trading systems that SEC must understand and monitor. The Internet has allowed for rapid, widespread dissemination of information to investors, which also presents ongoing regulatory challenges to which SEC has been responding. For example, the Internet has provided simple, effective, and essentially anonymous ways for unscrupulous persons to exploit investors. As of May 2001, SEC had brought more than 240 Internet-related enforcements actions, charging close to 800 persons and entities with federal securities law violations.

The internationalization of securities markets also presents new challenges for SEC. In 1991, U.S. investors purchased and sold $949 billion in foreign securities. By 2000, that number had risen to $5.484 trillion—an increase of 478 percent. According to SEC documents, in 2001, approximately 130 foreign companies from 29 countries entered U.S. securities markets for the first time and filed over $312 billion in public offerings. In addition, over 1,300 foreign companies from over 59 countries filed periodic reports. SEC also recognizes the importance of being able to work closely with its international counterparts in enforcement and inspection activities, and to participate in international initiatives that relate to the supervision of global securities markets.

Legislative Changes Spur New Products and Regulatory Responsibilities

Legislative changes also created additional workload for SEC. For example, GLBA made SEC the primary regulator for all securities firms, including broker-dealers and investment advisers affiliated with financial holding companies.[10] While SEC has always coordinated with other financial regulators to a certain extent, GBLA requires that SEC undertake additional examinations and inspections of highly complex financial services firms, both to fulfill its own oversight responsibilities and to provide the Federal Reserve and other relevant agencies with the

[10] Before GLBA, most banks' brokerage and investment adviser activities were not subject to SEC regulation.

information and analyses to fulfill their missions. Likewise, the Commodity Futures Modernization Act of 2000, which allowed single-stock futures to trade in the United States, increases the number of potential regulated entities over which SEC has responsibility. It requires futures markets and certain futures commission merchants[11] to register with SEC as national securities exchanges and broker-dealers for the limited purpose of trading these products. In addition, the USA PATRIOT Act of 2001 assigned to SEC an expanded role in the fight against money laundering and terrorism. SEC is working with the Department of Treasury on rulemakings related to shell banks, customer identification, suspicious activity reporting, and correspondent and private banking, as well as studies on managed funds and the overall operation of the legislation. SEC has expanded examination responsibilities for broker-dealer compliance under the Bank Secrecy Act and new examination responsibilities for other financial institutions regulated by SEC, including investment companies.

SEC's Ability to Fulfill Its Mission Has Become Increasingly Strained

SEC and industry officials said SEC's ability to fulfill its mission has become increasingly strained due in part to imbalances between SEC's workload (e.g., filings, complaints, inquiries, investigations, examinations, and inspections) and staff resources.[12] As figure 5 illustrates, since 1996 SEC's staff resources have not grown commensurate with its workload.[13] Although industry officials complimented SEC's regulation of the industry given its staff size and budget, both SEC and industry officials identified several challenges SEC faces. First, resource constraints have contributed to substantial delays in the turnaround time for many SEC regulatory and oversight activities, such as approvals for rule filings and exemptive applications.[14] Second, SEC's resource constraints contributed to bottlenecks in the examination and inspection area as workload grew. Third, limited resources have forced SEC to be selective in its enforcement activities and have lengthened the time required to complete certain

[11] Futures commission merchants are firms that buy and sell futures contracts as agents for customers.

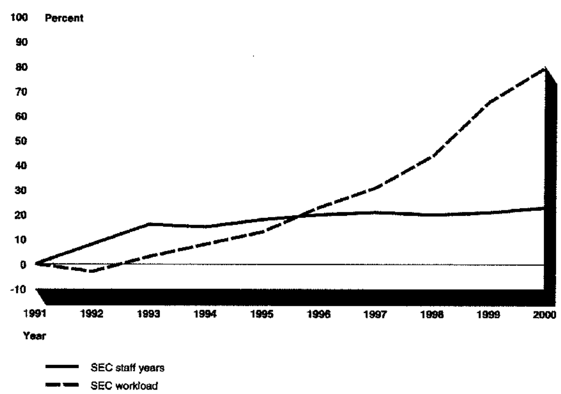
[12] Staff resources are measured in this report in terms of full-time equivalent staff years.

[13] Information presented throughout this report on SEC's staffing, resources, budget, and other operations relates to fiscal years.

[14] A company files an exemptive application when it seeks an SEC decision to exempt a new activity from existing rules and laws.

enforcement investigations.[15] Fourth, certain filings were subject to less frequent and less complete reviews as workloads increased. Fifth, today's technology-driven markets have created ongoing budgetary and staff challenges. Finally, SEC and industry officials said that SEC has been increasingly challenged in addressing emerging issues, such as the ongoing internationalization of securities markets and technology-driven innovations like ATSs and exchange-traded funds.

Figure 5: Percent Change in SEC Staff Years and Workload from 1991 to 2000



Source: GAO analysis of SEC data.

[15] The SEC chairman has recently announced an initiative called real-time enforcement, which is intended to protect investors by: (1) obtaining emergency relief in federal court to stop illegal conduct expeditiously; (2) filing enforcement actions more quickly, thereby compelling disclosure of questionable conduct so that the public can make informed investment decisions; and (3) deterring future misconduct through imposing swift and stiff sanctions on those who commit egregious frauds, repeatedly abuse investor trust, or attempt to impede SEC's investigatory processes. According to SEC, insufficient resources may inhibit the effectiveness of this initiative, which depends upon prompt action by enforcement staff.

SEC Resource Levels Have Not Grown Commensurate with Its Workload

Although there may not be a need for an identical offsetting increase in SEC staff compared to the increases in its workload, larger, more active, and more complex markets have produced more market participants, registrants, filings, examinations and inspections, legal interpretations, complaints, and opportunities for fraudulent activity. Over the last decade, staffing, within different areas of SEC's regulatory oversight activities, has grown between 9 and 166 percent, while workload measures in those areas have grown from 60 to 264 percent. As figure 6 illustrates, the increases in SEC's workload substantially outpaced the increases in SEC's staff. For example, the number of corporate filings increased 60 percent, while related review staff increased 29 percent. This figure also shows that the number of complaints and inquiries received increased by 100 percent, while the enforcement staff dedicated to investigate complaints and other matters increased by 16 percent.[16] In addition, the number of market and firm supervision actions increased 137 percent, but the number of staff responsible for these activities increased 51 percent. Market and firm supervision actions include

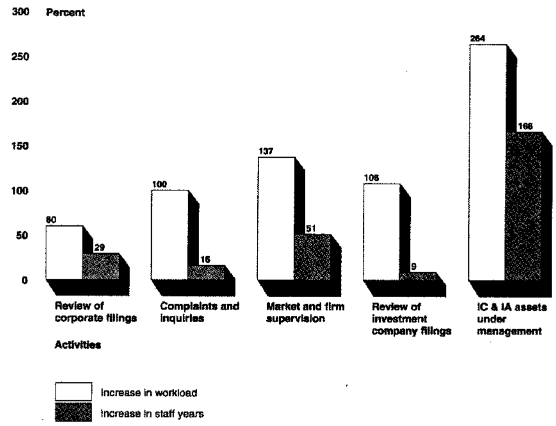
- SRO[17] and SEC rule proposals;
- interpretive guidance and exemptive applications;
- analyses of proposed enforcement actions, disclosure documents, and risk assessment reports;
- automated trading system analyses and automation reviews of SRO systems;
- policy papers;
- Congressional, governmental, industry, and public correspondence; and
- other reports and analyses of SEC's Division of Market Regulation.

Investment company filings increased 108 percent while staff increased 9 percent. Likewise, total assets under management by investment companies (IC) and investment advisers (IA) increased by about 264 percent over 10 years, while the number of IC and IA examination staff increased by 166 percent.

[16] Although complaints are not a comprehensive measure to compare with the level of investigative resources, many enforcement actions are initiated based on complaints received by SEC. Investigations might also be started, for example, from SEC inspections and examinations or matters referred to SEC by SROs or state regulators.

[17] SROs are organizations responsible for regulation of member broker-dealers.

Figure 6: Percent Change in Workload and Staff Years for Selected SEC Activities



Source: GAO analysis of SEC data.

Substantial Delays Exist in the Completion of Many Regulatory and Oversight Activities

The imbalance between workload and resources has resulted in SEC taking longer to process various types of filings, issue guidance, and review applications. Although SEC did not provide statistics on the time frames to process its workload, various industry officials told us they have to wait longer to receive SEC's response to their filings and applications. They said that SRO rule filings take longer to get approved as SEC's workload has increased. Likewise, the officials said that the amount of time SEC takes to process interpretive guidance and no-action letters[18] has increased, as has the length of time taken to process exemptive applications. Finally, the amount of time taken to review IPOs filings had also increased. The officials said these delays could affect industry competition and efficiency.

[18] A company would seek a no-action letter from SEC when it plans to act in a new or unclear area.

Backlog of SRO Rule Filings Has Grown

According to SEC officials, a growing backlog of SRO rule filings resulted in delays in responding to filings. As of January 2002, SEC officials said that there were 284 SRO rule proposals in the pipeline. The officials said that because of the high staff turnover in recent years, SEC did not have enough seasoned staff available to process the rule proposals more quickly. SEC data shows that the number of rule filings open at year-end increased 40 percent from 174 in 1998 to 243 in 2001. Also, SEC expects the number of SRO rule filings to continue to increase because of registration of new exchanges and the implementation of additional oversight responsibilities for exchanges trading single-stock futures. In 2001, SEC received 638 proposed rule changes compared to 444 in 1991—a 44 percent increase. Industry officials believed resource constraints were one reason that SEC now takes longer to complete these reviews than in the past. Such delays can have important affects on those making the filings. For example, an SRO official said that when SEC takes a year or more to approve a proposed change, the SRO can lose the competitive advantage from making the change. Although SEC officials said that they do not keep statistics on the length of time it takes to review filings, other industry officials said that they have waited months with no response from SEC.

In addition to approving SRO rule filings, SEC also develops its own rules. For example, in 2001, SEC developed 74 rule proposals and interpretive releases. One rule proposal SEC is considering would improve the SRO rule proposal review process. To address many of the concerns mentioned previously, the proposed Rule 19b-6 would, among other things, require SEC to (1) issue a release relating to filed proposed rule changes within 10 business days of receipt of the filing, (2) eliminate the pre-filing requirement and the 30-day delayed operational period before which noncontroversial rule changes can be filed or become operative, (3) expand the categories of proposed rule changes that qualify for immediate effectiveness to include certain trading rules, and (4) permit SROs to file proposed rule changes electronically. According to SEC staff, the initial rule proposal that was released over a year ago, in January 2001, was considered to be controversial. For example, some of the exchanges did not think the proposal went far enough in streamlining the rule filing process, while many broker-dealers were concerned about reduced SEC oversight. SEC is still considering comments it received from the industry and has not decided on the final contents of the rule.

Staff Constraints Result in Delays in Guidance

In addition to reviewing and approving SRO rule filings, SEC provides guidance to registrants, prospective registrants, and the public to help them comply with securities laws. This usually takes the form of

interpretive guidance and no-action letters, and each year SEC processes hundreds of these requests. Industry officials said that they have to wait longer to obtain SEC guidance in the form of no-action letters and interpretive guidance than in past years. SEC officials said that there were numerous no-action letters and interpretive guidance in process. In 2001, SEC processed over 1,600 requests for guidance from securities firms, investment companies, and investment advisors, which increased from about 1,360 in 1991. SEC staff also said that, as of January 2002, the chairman was reviewing SEC's interpretive guidance process. Industry officials said that delays in obtaining SEC guidance can create legal uncertainties and stifle innovation. In the future, although staff levels are expected to remain static, SEC expects its workload in this area to increase as more firms request guidance on how SEC's financial responsibility and investor protection rules apply to securities firms that become part of large financial services organizations and enter into increasingly complex financial transactions.

SEC Also Takes Longer to Review Exemptive Applications

SEC's processing of exemptive applications has also experienced delays. SEC is responsible for processing applications for exemptive relief from various statutory provisions and rules. The Investment Company and the Investment Adviser Acts authorize SEC to exempt any person, security, or transaction from one or more provisions of the acts. Exemptive applications usually take about 3 to 6 months to process but as the issues involved become increasingly complex it can take much longer. A 1996 SEC inspector general (IG) report[19] noted that it was not unusual for the length of time required for staff review to be a year or longer due to the complexity of the issues, the lack of delegated authority, or workload pressures.[20] Industry officials said that the time that SEC takes to approve exemptive applications has continued to increase and that inadequate staffing was part of the problem. For example, in the more extreme cases, an official said that SEC took over 1 year to process "a relatively routine" exemptive application and over 5 years to render a decision on another application. The IG also found that to avoid lengthy delays some firms abandoned plans that require exemptive relief or altered them to adopt a less innovative approach that did not require filing for an exemption.

[19]U.S. Securities and Exchange Commission, Inspector General, *Applications for Exemptive Relief*, Audit Report No. 230 (Washington, D. C.: March 1996).

[20] SEC is required to publish notice in the *Federal Register* of proposed exemptions giving interested parties the opportunity to request a hearing before a final exemptive order is issued. The notice period typically is 25 days.

Industry officials we spoke with also said that these delays stifled innovation and hampered competition.

SEC Reviews of IPO Filings Can Be Lengthy

Industry officials also said that the time SEC takes to approve IPOs has grown. Although the number of IPOs has decreased substantially in the past 2 years, industry officials continued to cite this as a challenge for SEC albeit a less pressing one. In 2001, SEC completed 745 IPO issuer reviews, down from 1,350 in 2000. SEC said that IPOs are a priority and that every IPO gets a full review. Industry officials said that it generally takes SEC 4 to 7 weeks to complete the review process, but the officials added that they see no reason that the process should take that long. These officials also said that the industry perception is that SEC's existing staffing level is insufficient given its workload. The length of time it takes to review an IPO has economic implications for the issuing company because market conditions can change (e.g., the estimated value of the stock can fall in adverse market conditions), thereby increasing the cost of the IPO or making the IPO not feasible. Moreover, the officials said that lengthy delays in the completion of IPO filings can increase the likelihood that issuers may opt for private placements or go offshore even if it is more costly. They also said that lengthy delays may discourage foreign companies from entering U.S. markets.

Workload Adversely Affects SEC Examination and Inspection Function

The increasing complexity and growth of the capital markets has also affected SEC's ability to inspect and examine the operations of various regulated entities. Each year, SEC usually conducts from 800 to 900 inspections and examinations of SROs, broker-dealers (including their branch offices and registered representatives), transfer agents, and clearing agents for compliance with the federal securities laws and regulations. To better utilize its resources, in the mid-1990s the Office of Compliance Inspections and Examinations (OCIE) began conducting fewer full scope examinations, which review all aspects of operations, and more frequent risk-based examinations, which focus on specific areas or issues.

Although staff levels are expected to remain unchanged in 2003, SEC expects the number of larger, more complex brokerage firms and other financial institutions to grow. SEC also expects to enhance its internal control examination program. These internal control examinations usually

take longer to complete and require special training and skills.[21] In 2001, SEC said that they conducted about 22 to 25 broker-dealer internal control examinations compared to 1 to 3 when they started the program in 1995. However, with no increase in staffing SEC may find it difficult to continue to increase the number of internal control examinations completed.

Although SEC officials said that they had been able to maintain their examination schedules and workload with their existing staff levels, some officials were concerned that the cycle for certain types of reviews could stretch beyond the planned time frames. For example, some officials said that the investment adviser reviews could stretch beyond the existing 5-year cycle in the future, if that examination program does not have sufficient resources. They added that a minimum review 1 in every 5 years was vital to the level of oversight needed to protect investors. SEC officials also said that new rules that have been implemented will add time and complexity to the reviews. Overall, SEC officials said that OCIE had lost a lot of experienced staff at the junior level and that new staff requires constant training.

Several industry officials also said that the time between the completion of SRO inspections and the issuance of final inspection reports is lengthy. SRO officials said that after an inspection is done it usually takes a year or two before the report is final. Some SRO officials said that the lag between the completion of the inspection and the issuance of the report could result in findings and recommendations becoming obsolete because the recommended changes had already been made or programs revised. These officials said that they would prefer to have the problem pointed out during the inspection process so as not to delay any necessary corrective action. Such lags in the inspection process can cause inefficiencies in SROs' operations.

According to SEC officials, other factors, in addition to resource constraints, also contribute to the extended time required to complete SRO inspections. SRO inspection reports require a more extensive level of review due to the variety of complex issues relating to SROs. Moreover, any recommendations must receive higher scrutiny because they could potentially impact SRO members. However, SEC officials said they recognize this is an issue and that steps are being taken to improve the

[21] Internal control examinations are intense reviews of internal controls relating to trading, liquidity, credit, new products, and other aspects of broker-dealer operations.

inspection process. For example, SEC plans to provide more detailed information about preliminary findings at exit interviews and inform SROs sooner about the issues that will likely be addressed in the final inspection reports. They also said that they plan to do more risk-based inspections of SROs.

Workload Growth and Limited Staffing Raise Concerns about Enforcement

SEC and industry officials said that delays in closing cases and a backlog of smaller investigations presented ongoing challenges for SEC. Between 1991 and 2000, Division of Enforcement staff devoted to investigations increased 16 percent, from 414 to 482 staff years, while the number of cases opened increased 65 percent, from 338 to 558. Although increased staff has allowed more work to be initiated, delays in completion of individual cases persist. Moreover, the number of cases pending at the end of the year increased 77 percent, from 1,264 in 1991 to 2,240 in 2000. SEC officials said the increase in cases pending was partly attributable to high staff turnover, which has resulted in old cases not being closed or ongoing cases being delayed until other staff can take over. The officials said that in 2000, 58 experienced staff left the division.

SEC and industry officials said that SEC's enforcement activities are important for carrying out SEC's mandate to protect investors and deter fraud and abuse. SEC officials said that they cannot prosecute every case and, therefore, must prioritize the cases they will pursue. SEC officials said they recognize that they have limited resources and operate accordingly. According to SEC officials, SEC generally prioritizes the cases in terms of (1) the message delivered to the industry and public about the reach of SEC's enforcement efforts, (2) the amount of investor harm done, (3) the deterrent value of the action, and (4) SEC's visibility in certain areas such as insider trading and financial fraud. Except for the length of time taken to complete an investigation, most officials said that SEC was effective in this area. Although SEC data show that the average length of time to complete an investigation decreased, we did not perform a detailed review of the individual investigations to determine whether this was an improvement or whether SEC on average pursued less time-consuming matters for investigation.

SEC Information Technology Systems and Funding Gaps Contribute to Inefficiencies

SEC and industry officials agree that SEC has improved its technological capabilities and expertise and has been proactive in creating innovative systems that assist the industry. However, SEC officials said that additional money is needed to improve the usefulness of many of its systems and to increase the technical knowledge of SEC staff. EDGAR[22] and the investment adviser registration depository (IARD) [23] systems were created to provide electronic collection, storage, and retrieval of data for the industry and investors. However, SEC staff and industry participants said that these systems provide limited capability to retrieve information. Currently, users can retrieve corporate and financial information from EDGAR, but the system is unable to generate trend information. SEC officials said that they must obtain this information from outside sources. An SEC staff member noted that the IARD system could be upgraded to include a variety of functions beyond storing investment adviser information including a search capability that identifies advisers according to state and specialty. However, the officials said that SEC was only allocated enough funds to meet the requirement of providing investors with a readily accessible database of information about investment advisers and persons associated with investment advisers. It did not receive sufficient funding to make the system fully useful for regulatory oversight or as an analytical tool.

According to SEC officials, SEC's 2002 information technology budget of $46.6 million was used primarily for hardware and software maintenance and technology infrastructure needs. These officials said that they requested, but did not receive, additional funding for capital improvements such as a nationwide network to support the examination and inspection activities and enhancements to the IARD. According to the officials, SEC has a list of technological improvement projects that have not been funded due to budgetary constraints. Several SEC officials said that requests have included applications that allow for better manipulation and connectivity of various SEC data systems and computerized reports. For example, one SEC official said that he must wait days for market surveillance data to be downloaded, even though technology exists that would allow SEC to obtain this information in seconds. The officials said that SEC's technology needs vary from having a simple toll-free number for investors

[22] EDGAR is a database system through which public companies electronically file registration statements, periodic reports, and other forms to SEC. Anyone can access and download EDGAR information for free.

[23] IARD is the system that investment advisers must use to register with SEC.

to contact SEC staff to having the capability to reconstruct trading activity in case of a major market failure, such as the 1987 market break.

SEC and the industry also cited the lack of additional technical staff as another issue. Some SEC officials said that they would like to have more information technology specialists to participate in certain examinations. One official said that SEC needs more technical specialists to evaluate industry participants' computer and information systems and to ensure compliance with new privacy laws that protect investor information and assets. As of January 2002, SEC had only two examination staff dedicated to technology issues involving broker-dealers and other non-SRO examinations.

SEC requested an additional $13 million in its 2003 budget authorization request to support the agency's information technology and automation efforts. Such funding was necessary to enable SEC to

- respond to federal requirements to expand electronic interactions with filers, registrants, the public, and other external customers;
- enhance SEC's examination and inspection program by providing automated tools to analyze large information databases used by investment advisers;
- upgrade the database, which is used in its investigative process to search and match lists of names received from other agencies;
- respond to federal requirements to ensure information security with better intrusion-detection capabilities and incident responsiveness and provide additional information security awareness training; and
- obtain the necessary hardware for creation of a "virtual private network" that will allow secure access for offsite inspection and examination activities.

SEC's oversight of SRO information systems is conducted through SEC's Automation Review Policy (ARP) program,[24] which in mid-2001 was administered by 10 staff members in the Office of Technology and Enforcement within the Division of Market Regulation. GAO reported in July 2001 that SEC's ability to oversee information system issues was hampered by the limited resources available to the ARP program, a factor

[24] ARP is a program under which SROs agree to submit to SEC oversight of their information systems.

that also constrained its staffs' ability to inspect the SRO's automated systems on a timely basis.[25]

Industry officials were not impressed by SEC's technology oversight. One industry official described SEC's technology reviews as fairly basic. Another industry official said that SEC staff had limited technical knowledge. This knowledge is vital for overseeing transaction systems including settlement and trading systems. And yet another industry official highlighted a "lack of confidence" in SEC's ability to effectively review technology and related capacity issues. SEC officials said that SEC has made improvement over the last several years and has tried to stay abreast of technological advances, but like most regulators SEC remains behind market developments.

Certain Financial Statement and Other Filings Are Subject to Less Frequent Review by SEC Staff

The number of corporate filings SEC received increased 59 percent from 61,925 in 1991 to 98,745 in 2000. The increase was primarily due to the tremendous increase in the number of IPOs and other market transactions filed with SEC. During this same time period, the staff years devoted to the review of these filings, primarily for accountants and attorneys, increased 29 percent from 125 in 1991 to161 in 2000. SEC officials said that this limited staff growth combined with the high volume of IPOs limited SEC's ability to review other filings, which also increased. The officials said that staff perform full reviews[26] of all registration statements for IPOs and may review other transactional filings related to raising capital or mergers and acquisitions. As a result, fewer resources are available to review the annual and quarterly filings of previously registered securities issuers. The percent of all corporate filings that received a full review, a full financial review, or were just monitored for specific disclosure items decreased from about 21 percent in 1991 when 13,198 were reviewed to about 8 percent in 2000 when 8,498 were reviewed.

[25] U.S. General Accounting Office, *Information Systems: Opportunities Exist to Strengthen SEC's Oversight of Capacity and Security*, GAO-01-863 (Washington, D.C.: July 25, 2001).

[26] SEC's review of corporate filings may involve a full review, a full financial review, or certain filings may be monitored for specific disclosure items. A full review involves an in-depth examination of the accounting, financial, and legal aspects of an issuer's filing. A full financial review involves an in-depth accounting analysis of an issuer's financial statements and management's discussion and analysis or business plan disclosure.

According to SEC officials, until the early 1980s, SEC completed full reviews of all transactional filings. The officials said that approach would not be possible in today's market without a substantial increase in staff resources. In addition, SEC's goal was to complete a full financial review of each issuer's annual filings in at least 1 of every 3 years—a review goal of about 30 to 35 percent of annual filings per year. According to SEC, this proposed level of review was expected to "ensure that material issues are disclosed clearly and completely and that possible fraudulent activities are addressed promptly." However, in 2001, SEC completed full or full financial reviews of about 16 percent, or 2,280 of 14,060 annual reports filed.

In November 2001, the Division of Corporation Finance announced that staffing levels were expected to remain flat while filings were expected to continue to increase and be more complex. In this post-Enron environment, SEC plans to reconsider its approach to determining how it will select filings for review and how it will review the filings selected. Rather than conducting full reviews of fewer firms, the officials said SEC may limit its review to a specific disclosure issue and review more filings for that issue. For example, SEC may choose to focus on off-balance sheet activities and work with the company to improve disclosure. However, the officials said that full reviews will not be completely abandoned, but the revised approach should help SEC better deploy limited staff resources and enable it to have a greater review presence across all types of corporate filings in the future. Further, in December 2001, in response to the disclosure and accounting problems of Enron Corporation, SEC said that it began reviewing the annual filings of the 500 largest U.S. companies.

SEC also reviews investment company filings, such as mutual fund prospectuses for compliance with disclosure requirements. As previously shown in figure 6, the number of investment company filings more than doubled from 17,143 in 1991 to 35,686 in 2000, while staffing for that activity increased by only 9 percent from 45 staff years in 1991 to 49 in 2000. However, the staff reviewed 33 percent of investment company filings in 1991 and increased that rate to 49 percent in 2000. SEC officials said the increase in the percentage of filings reviewed was due partly to changes in the types of filings coming into the agency, and partly to the fact that certain filings were counted as reviewed even though all aspects of the filings were not always fully reviewed. For example, if a mutual fund company introduces several new stock funds, only one of the new funds may be given a full review, and only the unique aspects of the other funds may be reviewed.

SEC Is Not Addressing Many Current and Evolving Issues

Both SEC and industry officials agree that the current level of human capital and budgetary resources has strained SEC's capacity to address current and evolving market issues. Industry officials generally hold SEC staff in high regard and said that SEC does a good job overall. However, industry officials also said that they would like to see SEC devote more effort to evolving and ongoing areas such as global market issues, technology, ATSs, financial statement reporting, and the net capital rule.[27] For example, one industry official said that SEC should be more proactive in coordinating with other regulators and industry in dealing with these issues. The official noted that SEC's reliance on a small number of seasoned staff to do the majority of the routine work does not allow those staff to adequately deal with new and emerging issues. For example, this official and others said that SEC needs to overhaul its approach to net capital to make use of modern risk management techniques. They said that SEC could benefit from hiring more financial economists to assist in this effort. They said that the current net capital rule imposes unnecessary costs on broker-dealers that deal in multiple products.

According to SEC officials, SEC lacks resources to deal with an increasing workload, review new products, and implement needed changes to rulemaking and policy interpretations. For example, one SEC official said that additional resources would be needed for SEC to review new products, like exchange-traded funds, and still be able to address its traditional workload. Likewise, recent high-profile accounting scandals, such as that involving Enron Corporation, have raised questions about SEC's ability to monitor disclosure requirements, which is vital to its goal of protecting investors.

Other Factors Contribute to the Challenges Facing SEC

In addition to the staff and workload imbalances, other factors also contribute to the challenges SEC currently faces. SEC officials said that, although additional resources could help SEC do more, additional resources alone would not help SEC to address its high staff turnover, which continues to be a problem. Furthermore, in recent years the staff turnover and large differentials in pay between SEC and other financial regulators and industry employers resulted in many staff positions remaining vacant as staff left at a faster rate than officials could hire new staff. Although SEC now has the authority to provide pay parity,

[27] The net capital rule, SEC Rule 15c3-1, is a liquidity standard that requires broker-dealers to (1) maintain a minimum level of liquid capital sufficient to promptly satisfy all of its obligations to customers and other market participants and (2) provide a cushion of liquid assets to cover potential market, credit, and other risks.

implementing it will depend upon SEC receiving sufficient budgetary resources. Industry officials also said that existing securities laws, which require SEC to approve market innovations and changes before they can be introduced into the market, can create a regulatory bottleneck. Industry officials said that there are steps SEC could take to avoid these bottlenecks and work more efficiently and effectively, such as by reforming its regulatory approval processes. Finally, we found that SEC's budget and strategic planning processes could be improved to better enable SEC to determine the resources needed to fulfill its mission. For example, unlike "high performing organizations," SEC has not systematically utilized its strategic planning process to ensure (1) that resources are best used to accomplish its basic statutorily mandated duties and (2) that human capital planning addresses the resource needs that are necessary to fulfill the full scope of its mission, including activities to address emerging issues.[28]

SEC and Industry Officials Cite Turnover as a Primary Challenge

As we noted in our 2001 report on SEC's human capital practices, about one-third of SEC's staff left the agency from 1998 to 2000.[29] SEC's turnover rate for attorneys, accountants, and examiners averaged 15 percent in 2000, more than twice the rate for comparable positions governmentwide. Although the rate had decreased to 9 percent in 2001, turnover at SEC was still almost twice as high as the rate governmentwide. Further, as a result of this turnover and inability to hire qualified staff quickly enough, about 250 positions remained unfilled in September 2001. SEC officials said that they could do more if they had more staff, but all cited SEC's high turnover rate as a major challenge in managing its workload. Likewise, industry officials agreed that many of the challenges SEC faces today are exacerbated by its high turnover rate, which results in more inexperienced staff and slower, often less efficient, regulatory processes.

From the industry's perspective, SEC's high turnover and resulting staff inexperience has contributed to many of the delays and problems discussed in the previous section. Industry officials said that, in the examination area, staff inexperience sometimes resulted in examinations taking longer to complete or focusing on procedural violations rather than

[28] High performing organizations are organizations that have been recognized in the current literature or by GAO as being innovative or effective in strategically managing their human capital.

[29] GAO-01-947.

substantive ones. At the beginning of 2000, 76 percent of examiners had worked at SEC fewer than 3 years. Likewise, from 1992 to 1999, the average tenure of an examiner declined from 2.9 to 1.9 years. SEC officials also told us that high staff turnover contributed to the delays in rulemaking and regulatory guidance discussed earlier. For example, SEC officials said that SEC has had problems retaining senior market supervision staff and that junior staff, on average, stay only for two years. In 1992, the average tenure for attorneys leaving SEC was 3.4 years, by 1999 the average had declined to 2.5 years. The officials said that this has contributed to the backlog in the SEC's rulemaking, interpretive guidance, and other activities. The officials also said that they have to constantly focus on current priorities, while other work gets put aside.

Although SEC and industry officials said that SEC would always have a certain amount of turnover because staff can significantly increase their salaries in the private sector, many said pay parity with other financial regulators could enable SEC to attract and retain staff for a few additional years. SEC estimated that a new employee generally takes about 2 years to become fully productive, and that pay parity could help them keep staff a year or two beyond the initial 2 years. Although industry officials said they were generally impressed by the caliber of staff that SEC hires and the amount of work they do, they said that staff inexperience often requires senior officials to become more involved in basic activities. Industry officials also said that certain divisions, such as the Division of Market Regulation, could benefit from more staff with a fundamental understanding of both how markets work and market experience. They said that such experience could help speed rulemaking and review processes. According to SEC, the Division of Market Regulation over the past two years hired six attorney "fellows"[30] with considerable industry experience. However, one attorney fellow recently informed the division that he will be leaving the program because of the failure to implement pay parity. SEC officials said that they have a difficult time attracting staff with market experience, given the government's pay structure.

Some officials said that SEC's turnover rate should decrease after pay parity is implemented. Presently, SEC professional staff are paid according to government pay rates. On January 16, 2002, the president of the United

[30] Like SEC's Office of the Chief Accountant, Market Regulation has a fellows program to attract seasoned attorneys. According to SEC officials, twenty percent of the division's GS-15 attorneys are attorney fellows.

States signed legislation that exempted SEC from federal pay restrictions and provided it with the authority necessary to bring salaries in line with those of other federal financial regulators. Although SEC now has the authority to implement pay parity, as of March 1, 2002, SEC has not received an additional appropriation to fund its implementation. In February 2002, SEC's chairman wrote to the chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, that SEC urgently needed pay parity and, that since the legislation had passed and become law, any decision not to support funding for pay parity would exacerbate the staffing problems it was intended to cure. The chairman also advised that SEC could "face even greater employee losses and suffer greater irreparable harm to morale" if pay parity was not funded. Therefore, it is too soon to determine the effect, if any, of pay parity on SEC's ability to attract and retain staff.

Industry Cites Challenges Posed by the Securities Laws

In addition to turnover, industry officials said that provisions in securities laws, which require upfront approvals, determine the pace at which SEC can approve market innovations the participants want to implement. For example, the Securities Act of 1933 and the Securities Exchange Act of 1934 generally require SEC to approve certain new products or market innovations prior to their implementation. Unlike banking regulators, who generally allow banks to engage in various banking-related financial activities unless they are specifically prohibited by statute, SEC must approve many new products before they can be introduced into the market. The securities laws also require SEC approval of new activities before market participants can adopt them. For example, SEC must approve exemptive applications that are filed by investment companies to engage in activities that may be prohibited by statute. However, as the number of these applications filed increases and the activities become more complex, SEC may be able to close fewer applications each year, and the time taken to close the applications may increase. As a result, registrants are unable to engage in certain activities until SEC approves them, which may put them at a competitive disadvantage. Although an in-depth analysis of this issue was beyond the scope of this report, some industry officials questioned whether the cost of delaying potentially useful products from entering the market outweighed the benefit of blocking a few harmful products.

Like any regulatory structure, provisions of these laws present advantages and disadvantages. First, the provisions enable SEC to prohibit new products or actions by industry participants that SEC believes to be harmful. Yet, SEC faces the difficult task of trying to evaluate the risks of

products that are untested in the market. Conversely, the provisions can also stifle innovations and advances in the market if the review process is cumbersome. Some officials said that it would be a more efficient use of SEC resources if SEC were able to focus on oversight instead of advanced approvals when the exemptive applications, or proposed rule filings, would have no adverse competitive effects on other market participants. However, SEC officials said that if new products and innovations were no longer subject to review and approval before their introduction, SEC would need significantly more examiners to monitor the new products and innovations after they were introduced.

SEC's Could Improve Its Budget Planning Process

Although SEC annually participates in the federal budget process, SEC has not reviewed its staffing and resource needs independent of the budget process. That is, SEC generally develops its annual budget request based on the previous year's appropriation, not on what it actually would need to fulfill its mission. Although SEC officials said that they can shift staff from one area to another to address new priorities, SEC's reactive approach can result in regulatory gaps. Comprehensive strategic planning that relates SEC's resource needs to its ability to fulfill its mission could help SEC better identify and manage resource needs.

SEC's Budget Process Begins with the Past Year as a Base

SEC officials said that the annual budget cycle begins with the preparation of an agency-wide estimate based on the previous budget year's appropriation. Next, SEC develops a conforming budget estimate based on the budget guidance, including a specified budget amount that the Office of Management and Budget (OMB) provides to SEC. SEC budget staff then asks officials from each of SEC's divisions and offices to review and update program information and provide estimates of their resource needs. However, the division and office officials said that they are often told how much of an increase they can request in order to be consistent with the budget guidance. The budget staff coordinates the requests and discusses staffing needs with the division and office officials. SEC's proposed budget estimate is then sent to OMB, and a budget hearing is subsequently held. During the hearing, any policy changes or shifts in the SEC chairman's priorities are discussed. SEC's budget estimate is incorporated into the president's budget, which is presented to Congress. However, before the budget is final, SEC has the opportunity to appeal to OMB to modify its approved funding level. SEC's funding level is also

subject to congressional review and appropriation before it becomes final.[31]

In addition to its budgeted funding level, SEC also has a "no-year account," which consists of certain fees collected and funds that have been appropriated over the years but not expended by year-end. SEC, like several other agencies, is allowed to keep appropriated funds that are not expended at the end of the year.[32] Money in this fund is generally used for one-time expenditures that are not included in the annual budget. SEC officials said SEC can use funds from the no-year account after OMB and Congress approve these expenditures. SEC officials said that money from the no-year account was used to pay expenses incurred to reopen SEC's Northeast Regional Office, which was located at 7 World Trade Center, following September 11th.[33] SEC also used money from the no-year account to modernize its EDGAR system. Although SEC had over $75 million in its no-year account in fiscal year 2001, SEC officials said that Congress rescinded $50 million from the no-year account as part of SEC's 2002 appropriation. As of the beginning of fiscal year 2002, SEC had about $25 million in its no-year account.

Similar to banking regulators collecting assessments and fees from banks, SEC collects fees on registrations, certain securities transactions, and other filings and reports. However, unlike the banking regulators, which are self-funded, SEC deposits its collections in an SEC-designated account at the U.S. Treasury that is used by SEC's congressional appropriators for, among other things, providing appropriations to SEC.[34] Public Law 107-123, which authorized pay parity for SEC, also amended the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939 to reduce the fees collected by SEC while providing a stable long-

[31] Separate from this process, SEC also prepares a budget authorization request that gives it a greater opportunity to independently determine its needs and make a corresponding request, which is submitted to SEC's congressional oversight committees.

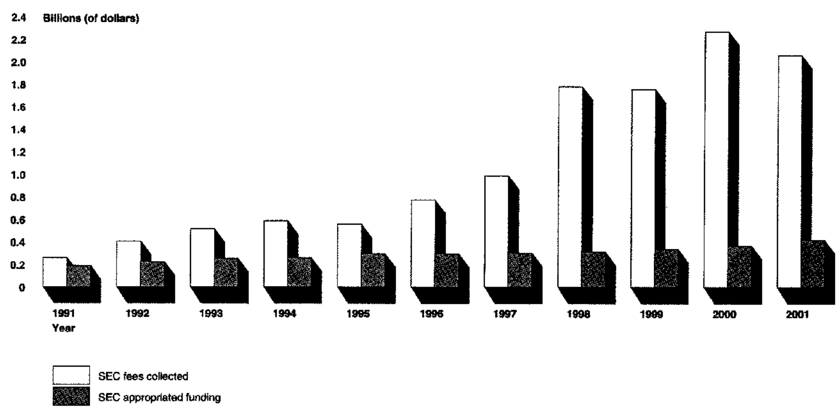
[32] The Departments of Commerce, Justice, State, and the Judiciary, for example, are also able to keep unspent funds.

[33] SEC was subsequently reimbursed for the expenses it incurred as a result of the attacks.

[34] Federal banking regulators, like the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency are self-funded and are not subject to the federal budget process. These agencies are funded from fees and assessments collected and earnings on investments.

term funding source for SEC.[35] According to SEC, even after the fee reduction, SEC fee collections are projected to bring in a sizable amount of revenues, of which those in excess of SEC's appropriation would be available to fund other programs. For example, in 2003, SEC appropriators will have approximately $1.3 billion in projected SEC fee collections from which to fund the agency versus the president's request of about $467 million.[36] In 2001, SEC collected almost $2.1 billion compared to its appropriated funding of $423 million. SEC fee collections and appropriated funding levels are shown in figure 7.

Figure 7: SEC Fees Collected and Appropriated Funding, 1991-2001 (billions of dollars)



Source: SEC.

[35] The law also mandated a GAO study of SEC self-funding, which is currently under way.

[36] The amendments include complex formulas designed to adjust SEC fee rates to result in predetermined amounts of fee collections over the next 9 years. Projected fee collections in excess of SEC's appropriation are available to fund other programs. Prior to the amendments' enactment, SEC was required to deposit a significant portion of its collections in the Treasury for general use. The amendments eliminated such deposits.

To respond to expanding markets and new challenges, SEC has requested additional resources and funding. For example, in 2001, SEC received funding for an additional 50 positions. However, in its 2002 budget, it lost 57 positions in order to absorb mandatory inflation-related increases that were not covered by its budget.[37] However, SEC received $3.9 million for special pay rates for its most experienced attorneys, accountants, and examiners in 2002. In its May 2001 authorization request submitted to Congress, SEC requested an additional $70 million in 2002, with adjustments for inflation for years thereafter, to fund staff pay parity. In addition for 2003, SEC requested authorization for an additional $36.4 million and 261 positions. According to SEC, these additional staff resources would allow it to (1) respond to new regulatory, oversight, and examination requirements of GLBA; (2) undertake joint regulation of the market for single stock futures and narrow-based index futures under the Commodity Futures Modernization Act of 2000; (3) enforce and support its new auditor independence rules; (4) monitor and review exchange automation efforts; and (5) continue combating Internet fraud and insider trading. As previously noted, SEC also requested an additional $13 million to support its information technology initiatives. The president's budget for 2003 did provide SEC an additional $7.6 million for certain technology and security initiatives but did not provide funding for any additional staff or for pay parity. As a result, SEC will continue to be restrained from fully addressing the new regulatory challenges and growing workload that it faces.

Strategic Planning Could Help SEC to Better Identify and Manage Its Resource Needs

Previous GAO reports noted that high-performing organizations identify their current and future human capital needs—including the appropriate number of employees, the key competencies needed for mission accomplishment, and the appropriate deployment of staff across the organization—and then create strategies for identifying and filling any gaps.[38] SEC generally has identified its available resources and determined what could be accomplished with existing staff. However, its inability to meet its goals due to resource constraints has resulted in SEC reconsidering the goals, for example, in its approach to selecting

[37] SEC was unaffected by this reduction in 2002 because it was absorbed from the agency's many vacant positions, about 250 at the time.

[38] See U.S. General Accounting Office, *Managing for Results: Next Steps to Improve the Federal Government's Management and Performance*, GAO-02-439T, (Washington, D.C.: Feb. 15, 2002) and *Determining Performance and Accountability Challenges and High Risks*, GAO-01-159SP, (Washington, D.C.: Nov. 2000).

corporate filings for review and the type of review selected. According to SEC officials, SEC's ability to redeploy its staff is limited by existing statutory requirements, which define the responsibilities that SEC must carry out and determine its use of the staff. Nevertheless, in determining how to address evolving issues, ideally, SEC would periodically evaluate the related resources needed to fulfill the full scope of its mission and develop strategies to achieve its goals.

We performed a limited review of SEC's strategic plan in light of its ongoing resource limitations and increased workload. We found that SEC has not engaged in a comprehensive strategic planning process. SEC's GPRA strategic plan includes four goals: "protect investors; maintain fair, honest, and efficient markets; facilitate capital formation; and sustain and improve organizational excellence." However, the performance measures for achieving these goals focus on outputs not outcomes. For example, SEC's objectives for protecting investors include deterring fraud and requiring compliance with the federal securities laws, promoting informed investment decisions, and promoting the prevention of fraud through investor education. However, the output-oriented performance measures include the number of enforcement actions taken, filings reviewed, examinations completed, and deficiencies identified. These measures generally would not help SEC gauge whether the actions taken actually result in greater protection for investors or establish the levels of these actions and activities needed to achieve its goals. In its annual GPRA performance plan and report, SEC has recognized that its performance measures are not outcome-oriented.

In addition to its 5-year strategic plan, SEC develops annual programmatic budget estimates and GPRA performance plans and reports addressing its strategic goals and performance results. However, neither of these documents provide the detailed analysis and information needed to make informed workforce decisions, including information on (1) the relationship between budget requests for full-time equivalent staff years and the ability to meet individual strategic goals and (2) any excesses or gaps in needed competencies within the agency's various divisions and offices. Such an analysis would call upon each division and office to accurately identify the human capital resources needed to achieve their respective strategic goals. This information could help SEC better determine the right size, skill needs, and deployment of its workforce to fulfill its goals and mission.

Conclusions

Securities markets have undergone tremendous growth and change over the past decade. More individuals than ever are invested in securities markets, either directly or through mutual funds. Likewise, these markets have become more complex and global as technology has fundamentally changed the way markets operate and how investors around the world interact with the markets. Moreover, the recent, sudden collapse of Enron Corporation and other corporate failures have stimulated an intense debate on the need for broad-based reform in such areas as financial reporting and accounting standards, oversight of the accounting profession, and corporate governance. All of these areas of possible reform hold significant repercussions and pose challenges for SEC's oversight role. At the same time, SEC has been faced with an ever increasing workload and ongoing human capital challenges, most notably high staff turnover and numerous vacancies.

SEC routinely prioritizes and allocates resources to meet agency demands, but SEC faces increasing pressure in managing its mounting workload and staffing imbalances that resulted from its workload growing much faster than its staff. Critical regulatory activities such as reviewing rule filings and exemptive applications and issuing guidance have suffered from delays due to limited staffing. According to industry officials, these delays have resulted in foregone revenue and have hampered market innovation. Oversight and supervisory functions have also been affected. For example, staffing limitations and increased workload have resulted in SEC reviewing a smaller percentage of corporate filings, an important investor protection function. In 2001, SEC reviewed about 16 percent of the annual corporate filings or about half of its annual goal of 30 to 35 percent. Although SEC is revamping its review process, recent disclosure and accounting scandals illustrate how important it is that SEC rise to the challenge of providing effective market oversight to help maintain investor confidence in securities markets. Although industry officials said that the challenges faced by SEC were in part attributable to resource constraints, they cited other issues such as SEC's high turnover rate, which in 2001 was almost twice the governmentwide rate. They said that SEC's high turnover created a staffing drain that often resulted in slower, less efficient regulatory processes. We explored the reasons for SEC's turnover rate and actions taken to address this problem in our 2001 human capital report.

Although SEC has taken numerous actions to address its high turnover including use of special pay rates and retention bonuses, the lack of funding for pay parity will provide little needed relief in the short-term. In the 2001 report, we also identified several issues beyond pay that warranted ongoing attention by management and recommended actions

on these issues that could help SEC mitigate its turnover problem. These actions included conducting periodic employee surveys to identify staff concerns, expanding SEC's human capital plan to include a strategy for succession planning, finding ways to involve human capital leaders in decision making, and working with the union to address the areas of dissatisfaction identified in our 2001 survey (i.e., lack of opportunities for advancement, the amount of uncompensated overtime, and quality of administrative support services).

Although SEC's workload and staffing imbalances have challenged SEC's ability to protect investors and maintain the integrity of securities markets, SEC has generally managed the gap between workload and staff by determining what basic, statutorily-mandated duties it could accomplish with existing resource levels. This approach, while practical, has forced SEC's activities to be largely reactive rather than proactive. For instance, SEC has not put mechanisms in place to identify what it must do to address emerging and evolving issues. Although SEC has a strategic plan and has periodically adjusted staffing or program priorities to fulfill basic obligations, SEC has not engaged in a much needed, systematic reevaluation of its programs and activities in light of current and emerging challenges. Given the regulatory pressures facing SEC and its ongoing human capital challenges, it is clear that SEC could benefit from some additional funding. However, a comprehensive, agencywide planning effort could help SEC better determine the optimum human capital and funding needed to fulfill its mission.

Recommendations for Executive Action

We recommend that the chairman, SEC, develop short-term and long-term strategies to address the challenges SEC faces. In the short-term, we recommend that SEC take definitive steps to continue to address its turnover problem and fill its vacant positions. These actions should include exploring use of its no-year fund to expand recruiting and retention efforts to ensure that all available resources are maximized to attract and retain staff. Likewise, we recommend that SEC explore innovative ways to attract senior level staff and bring in additional information technology expertise to better position itself to oversee evolving securities markets.

In the long-term, we recommend that the chairman, SEC, address several issues relating to strategic planning by broadening SEC's strategic planning process to systematically determine regulatory priorities and resource levels needed to fulfill its mission. Furthermore, we recommend that once SEC has completed the strategic planning process, each division

and office accurately identify the skills needed to perform the regulatory priorities identified. Once this is completed, we recommend that SEC link the strategic plan to staffing allocation and workforce determinations and expand its existing recruiting effort to include any additional disciplines identified as necessary to effectively regulate evolving securities markets.

Agency Comments and Our Evaluation

SEC provided written comments on a draft of this report that are reprinted in appendix I. In general, SEC agreed with most of the report's findings, conclusions, and recommendations. In particular, SEC strongly supported our recommendation that strategic planning could help SEC better identify and manage its resource needs. SEC said that it had earlier planned to perform an in-depth review of its operations, effectiveness, and resource needs. However, the events of September 11th, the loss of SEC's Northeast Regional Office, and the recent bankruptcy of Enron Corporation have prohibited that review. Nevertheless, SEC stated that it was committed to completing an in-depth review of SEC's resource needs.

In response to our recommendation that SEC take definitive steps to address its staffing problem, SEC agreed that the lack of funding for pay parity would provide it with little needed relief in the short term. However, SEC stated that, despite the lack of funding, it was planning to implement and manage pay parity within the agency. SEC will soon submit a Pay Parity Implementation Report to Congress and the Office of Personnel Management. The report is to consider the challenges SEC faces in implementing pay parity in light of all of the various interests in the issue. Although we have not reviewed SEC's specific implementation plan, developing a plan to implement pay parity is a vital step in improving SEC's staff recruiting and retention efforts.

Scope and Methodology

To determine how the markets and SEC's workload have changed, we analyzed various securities markets and SEC workload trend data. The various workload data used include numbers of corporation and investment company filings, complaints and inquiries, rule proposals, various industry interpretive and exemptive requests, investigations opened, and investment company and investment adviser assets under management, and examinations and inspections conducted. These workload data are published as part of SEC's annual budget request. We did not attempt to verify any of these data.

To determine whether SEC's resources and workload have affected SEC's ability to regulate and oversee the markets, we interviewed current and

past SEC officials, including division and office directors, regional office directors, budget officials, former commissioners, and academics. Likewise, to obtain views from industry officials regarding how well SEC is functioning; we met with officials from various exchanges, associations, investment companies, and broker-dealers. Although SEC and industry officials agreed that the length of time taken to complete various reviews and issue guidance had increased, we were unable to quantify these effects, because SEC was unable to provide consistent detailed statistics on the time it takes to complete certain regulatory processes for the program areas discussed in the report such as reviewing filings, issuing guidance, and reviewing applications. We also obtained these parties' views about any other factors that may affect SEC's ability to fulfill its mission.

We also met with OMB officials regarding SEC's budget and the federal budget process. We met with banking industry regulators to obtain information on their funding and budget processes. We reviewed SEC GPRA performance plans and reports and recent GAO reports that address strategic planning at high performing organizations. We also reviewed relevant GAO reports on SEC's oversight and its operations.

We did our work in Los Angeles and San Francisco, California; Washington, D.C.; and New York, New York, between April 2001 and February 2002 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the ranking minority members of the Senate Committee on Banking, Housing, and Urban Affairs and its Subcommittee on Securities and Investment; the chairman and ranking minority member, Senate Committee on Governmental Affairs; the chairman and ranking minority member, House Committee on Financial Services; and other interested congressional committees. We will also send copies to the chairman of SEC and will make copies available to others upon request.

If you or your staff have any questions regarding this report, please contact me or Orice M. Williams at (202) 512-8678. Key contributors to this report were Toayoa Aldridge, Edwin Lane, Barbara Roesmann, and David Tarosky.

Richard J. Hillman

Richard J. Hillman, Director
Financial Markets and Community Investment

Appendix I: Comments from the Securities and Exchange Commission

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

February 28, 2002

Mr. Richard J. Hillman
Director
Financial Markets and Community Investment
U.S. General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Re: Draft Report Entitled SEC Operations: Increased Workload Creates Challenges

Dear Mr. Hillman:

Thank you for the opportunity to review and comment on the General Accounting Office's draft report addressing whether the Securities and Exchange Commission has sufficient resources to stay abreast of changes in the securities markets. The report identifies how securities markets have changed in recent years, and assesses whether the SEC's resource levels and workload have affected the Commission's ability to regulate and oversee the markets.

We agree with most of the conclusions that GAO draws in the draft report. In particular, we agree that securities markets have experienced unprecedented growth and change in the last decade, that the markets have become more complex and international, and that legislative changes have spurred new products and created new regulatory responsibilities. We also agree that the SEC's ability to fulfill its mission has become increasingly strained. As noted in the report, SEC resource levels have not grown commensurate with its workload, and the SEC faces continuing challenges from its high staff turnover rate and difficulty in hiring qualified staff.

We also strongly support the report's recommendation that strategic planning could help the SEC to better identify and manage its resource needs. When I returned to the SEC last fall, I had hoped to have the opportunity to perform an in-depth review of the Commission's operations, effectiveness, and resource needs prior to the beginning of the fiscal 2003 budget process. With the events of September 11th, the loss of our Northeast Regional Office, and the recent bankruptcy of Enron, I have not had the time to conduct a thorough review. Nevertheless, I am committed to completing an in-depth review of the SEC's resource needs in the coming months.

With respect to our staffing challenges in particular, we agree that the lack of funding for pay parity will provide us with little needed relief in the short term. It is critical that we receive current and future funding to implement an effective new compensation system. However,

Mr. Richard J. Hillman
Page 2

despite the lack of funding, we have developed a plan to implement and manage pay parity within the agency.

In accordance with the directive in the Investor and Capital Markets Fee Relief Act (P.L. 107-123), we soon will submit a Pay Parity Implementation Report to Congress and the Office of Personnel Management. The Report considers the challenges we face in implementing pay parity in light of all of the various interests in the issue. In developing our compensation system, we strove to strike a delicate balance among competing interests that include the goals of the Administration, the concerns of Congress, and equity issues within the Agency. Recognizing our responsibility to appropriately manage performance as we improve staff compensation, our system includes implementing a strong system with merit/pay-for-performance principles, not large, across-the-board pay increases that we believe are inappropriate for the federal service.

We tried to take best practices from all areas when developing this system and to learn from the experiences of the other financial regulatory agencies. Our intent with this reasonable approach is to provide increases to all staff in a way that can be implemented quickly, while also recognizing that this will be an on-going, long-term effort. In seeking comparability with the other federal financial regulatory agencies, the SEC and our compensation consultant conducted various analyses of the salary and benefit structures that they provide. The research shows that there is a range of approaches available and that differences do exist among how each agency has decided to compensate their staff and how successful they have been.

To ensure that the SEC acts responsibly, we are taking a rather conservative approach that will place the agency's proposed salary structure toward the lower end of those that we analyzed. We believe this will allow us the opportunity to ascertain over time how well our system is working before we get locked into a structure that might not meet our goals. In addition, the mix between salaries and benefits is not yet known at this time, as these items are negotiable with the union that represents a majority of SEC employees. To begin the program we plan to maintain the same benefits as are currently available to all Federal employees.

Our proposed pay scale has 20 levels, each with up to 31 steps. Most staff will be placed within levels 1 through 17 (that include two additional supervisory levels), as opposed to the current 15 general schedule grades. Levels 18 through 20 are the executive levels with broad pay ranges, instead of the current 6. The step structure is designed to make extra steps available to attorneys, accountants, and securities compliance examiners with securities industry experience. Our goal is to apply this new structure so that we can have a broader range of salaries available to aid in hiring new employees and to provide incentives to staff to improve their performance.

With respect to our immediate resource needs, we are conducting an evaluation as part of the fiscal 2003 budget process. As you know, the authorization process gives the SEC the opportunity to independently determine its needs and make a corresponding budget request. We are actively engaged in this process.

Mr. Richard J. Hillman
Page 3

While I cannot predict with absolute certainty what the results of our in-depth evaluation of resource needs will be, we will conduct the review recognizing the challenges we face, asking ourselves tough questions, and remaining mindful of the competing and important priorities our government faces.

Thank you and your staff for the courtesy extended during this review.

Yours truly,

Harvey L. Pitt

Harvey L. Pitt

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United States General Accounting Office

GAO

By the Comptroller General of the United States

March 2002

HIGHLIGHTS OF GAO'S CORPORATE GOVERNANCE, TRANSPARENCY AND ACCOUNTABILITY FORUM

GAO

Accountability ★ Integrity ★ Reliability

GAO-02-494SP

GAO
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

March 5, 2002

Subject: Highlights of GAO's Corporate Governance, Transparency, and Accountability Forum

The recent sudden and largely unexpected bankruptcy of one of the nation's major corporations, Enron Corporation, and the financial difficulties being experienced by several other large corporations have resulted in substantial losses to employees and shareholders. Many believe that the decline of Enron and other instances of financial statement earnings restatements and bankruptcies have resulted in a general decline in investor confidence in our financial markets and in certain key parties under our current system, such as external auditors. These events have also raised a range of questions regarding how such dramatic and unexpected dealings can happen under our current system and the role of various key players under that system. As a result, a number of congressional committees and executive branch agencies have initiated Enron related investigations.

The Congress has asked GAO to examine many of the systemic issues arising from its oversight in connection with these matters. In particular, the Congress and GAO are interested in changes that could serve to reduce the possibility of other Enron-like situations occurring in the future. To provide us with a foundation to help inform this work, on February 25, 2002, we convened a forum on corporate governance, transparency, and accountability. Forum participants included individuals from federal and state government, the private sector, standards setting and oversight bodies, and a variety of other interested parties.

The forum was designed to discuss systemic issues, including accounting and reporting, corporate governance, auditing, pensions, oversight, and other selected matters. As expected, the forum participants expressed a range of views on these broad topics, which do not necessarily represent GAO's views. However, there was general agreement that there are no simple solutions, or a single "silver bullet," and that the Congress needs to be careful not to act on perceived problems without appropriate review and analysis. To do otherwise may result in actions with unintended consequences. Several other key observations follow.

- Potential investors and shareholders would benefit from financial information that is more timely and understandable, including reporting of key trends, performance indicators, and risk-related information.

- Accounting and reporting rules should be based on "economic substance" of the related transactions and should employ a "substance over form" doctrine in resolving related matters. Auditors should place additional emphasis on whether the financial statements "fairly present the financial condition" of the entire entity in all material respects rather than merely assuring that the financial statements are presented "in accordance with generally acceptable accounting principles." Auditors should also assure that the financial statements are not "materially misleading."

- Management is primarily responsible for a firm's financial condition and related financial reporting. Those in key corporate leadership positions, as well as external auditors, must set the tone for managing ethically and with integrity.

- Audit committees have an important role to play in overseeing and interacting with internal and external auditors.

- External auditors should view shareholders as their clients versus management, and they must maintain independence and stand firm in resolving key financial reporting and audit issues. In this regard, external auditors play an important safety net role to protect the shareholders, the public, and others.

- Because defined contribution plans that provide participant-directed investments have experienced significant growth, more emphasis needs to be placed on providing additional education and appropriate advice to plan participants.

- Consideration should be given to providing greater parity between senior management and other employees, including 401(k) plan participants, in connection with the ability to sell stock or other equity instruments.

- Steps need to be taken to strengthen enforcement of existing requirements and to hold the responsible parties fully accountable for any related problems. This should involve both civil and criminal sanctions, as appropriate.

- Additional safeguards, more effective oversight, and tighter enforcement by regulators and others will not necessarily prevent businesses from failing. However, greater attention to these issues is necessary to help ensure that investors adequately understand related risks, financial performance is measured in an accurate and timely manner, and conflicts of interest are identified and properly dealt with.

Appendix I includes further highlights of the matters discussed by the forum's participants, who are listed in appendix II. Prior to the forum, we provided them with possible questions for discussion, which are shown in appendix III. We anticipate that the forum members will meet in the future to again share knowledge and provide current perspectives on these issues, which are of great concern to the financial well-being of the nation and its citizens. This document will be posted to our website at www.gao.gov.

I wish to thank each of the forum participants for providing their insights on the important matters this document discusses. I appreciate their willingness to spend their time and to provide their views in connection with various matters concerning corporate governance, transparency, accountability, and other issues.

David M. Walker
Comptroller General
of the United States

Appendix I

GAO's Corporate Governance, Transparency, and Accountability Forum

Highlights of the Forum Discussion

The forum's overall objective was to have an informal and interactive discussion regarding certain systemic challenges, such as those associated with the recent decline of Enron. Some have questioned how an entity such as Enron could fall so quickly and unexpectedly. Many believe that the decline of Enron and other instances of financial statement earnings restatements and bankruptcies have resulted in a general decline in investor confidence in our financial markets and in certain key parties under our current system, such as external auditors. While the focus of the forum was not on Enron per se, it serves to illustrate a number of the systemic and interrelated challenges that need to be addressed.

Addressing these challenges will involve the public, private, and not-for-profit sectors. In general, there must be the proper incentives, transparency, and accountability mechanisms in place to ensure the effectiveness of any system. As a result, these principles were considered in connection with all of the issues discussed.

Accounting and Financial Reporting

The forum participants identified the following as important issues to be addressed in designing an updated accounting and financial reporting model.

- Accounting and reporting rules should be based on "economic substance" of the related transactions and should employ a "substance over form" doctrine in resolving related matters.

- There are trade-offs between principles-based and rules-based accounting standards. Principles-based standards should focus on substance over form and may result in volatility and inconsistent implementation among entities. Rules-based standards, however, can be too detailed and compliance oriented and focus more on form over substance. They can also lead to attempts by key parties to ask "show me why I can't do this?" Both approaches require that all key parties have integrity and exercise good judgment.

- International accounting standards are moving toward a more principles-based approach. Ultimately, we may see more of a convergence between international and United States accounting standards.

- It may be feasible to have more rigorous reporting requirements for larger entities, particularly those that pose a greater individual risk to capital markets, investors, and others. Investors, though, should be clear on any differing requirements.

- It is often difficult for investors and other users, even experts, to understand the complexities of current financial reporting, including for example, disclosures on derivatives and special purpose entities. Steps should be taken to help assure that investors have the ability to comprehend and inquire about any issues with significant implications on value or risk. It will be a challenge to define the degree of required understandability, given the wide disparity of expertise among investors.

- There has been a proliferation of pro forma financial statements, which allows "spin" in reporting financial results and causes confusion for investors and others in understanding a corporation's true financial picture and prospects.

- There is a fair amount of interest in more useful and timelier reporting, perhaps on a quarterly or even more frequent basis. However, such reporting will require even greater communication to explain the swings in financial results and may require accounting standards setters to evaluate current provisions for leveling or "smoothing" financial results over multiple periods.

- There is need for more timely, useful, and consistent information about important trends and key performance indicators. This type of information needs to be considered in connection with any broader reporting model.

Auditing

Forum participants identified the following key issues related to auditing.

- Auditors should view shareholders as their clients versus management. The board of directors and the audit committee serve as agents for the shareholders and have a fiduciary responsibility to them.

- Auditors should place additional emphasis on whether the financial statements "fairly present the financial condition" of the entire entity in all material respects rather than merely assuring that the financial statements are presented "in accordance with generally acceptable accounting principles." Auditors should also assure that the financial statements are not "materially misleading."

- Auditors need to stress their independence over any other business relationships or potential conflicts of interest with their clients. They should emphasize with management the need for making the right disclosures rather than ascertaining whether the rules do not preclude management-preferred forms of disclosure.

- Consideration might be given to strengthening independence by looking at periodic audit firm rotation, renewable terms, or periodic rotation of all key personnel assigned to an audit within a firm. Rotation, though, is costly in terms of an extended start-up time due to lost experience, particularly for larger entities with complex finances.

- Consideration might also be given to adopting a variety of auditing models, such as more joint auditing, instead of a "one firm does all" approach. For example, Canada requires big banks to have two auditing firms.

Pensions and Savings Plans

Forum participants identified the following key issues related to employee pension and savings plans.

- The advent of 401(k) plans and a decrease in defined benefit plans have caused employees, rather than employers, to bear related investment risks.

- The average plan participant does not have sufficient amounts in their 401(k) plans to retire at ages such as 55 years.

- Plan participants are not required to diversify their portfolios and may too narrowly concentrate their portfolios on a single stock of interest to them, such as their employer. For this and other reasons, the investing public may not necessarily want a paternalistic approach from government on investment options and choices. However, they may need more flexibility to reallocate employer matching contributions from stock to other forms of investment in a more timely manner than required under current law.

- Many employees may also want to share in the growth and success of an entity they work for, and employers may want to use stock and/or stock options to ensure or increase company loyalty and better align employee interests with those of the company and other shareholders. There are many successful examples of entities with employee stock ownership and stock option plans. There are also examples of when such plans were not successful.

- A large segment of the investing public, including 401(k) plan participants, may not have all the knowledge necessary to make intelligent investment decisions, and may want or need additional education and appropriate investment advice. For example, they need additional assistance to better understand the need for diversification and the risks associated with building large percentages of their account in any one investment, especially employer securities.

- Consideration should be given to requiring more transparency and parity in the rights of senior management vis-à-vis plan participants, particularly as to the rights to sell company stock during plan freezes or lockdown periods.

Corporate Governance

Forum participants identified the following key issues related to corporate governance.

- The United States is largely viewed as having the most effective capital markets in the world, and the current system of corporate governance has generally supported these markets and the overall economy of the United States over the past several decades.

- It is not readily clear whether the spate of recent business failures and earning restatements, such as Enron, is a result of systemic weaknesses in the current corporate governance structure. Any major revisions to corporate governance models should be considered only after obtaining and analyzing as much information as possible from past failures and restatements.

- A governmental body, or unit, modeled perhaps after the National Transportation Safety Board, and whose sole purpose would be to investigate large business failures, could lead to more immediate results and help to prevent such failures in the future. This body, or unit, would need to draw upon expertise from a variety of governmental and nongovernmental entities in discharging its mission.

- Management is primarily responsible for the accuracy and integrity of an entity's financial reporting, internal controls, performance reporting, and compliance with applicable laws and regulations, as well as for establishing and enforcing an appropriate code of conduct.

- The integrity and competency of top management, often referred to as the "tone at the top," are critical factors in an entity's ultimate success. The nominations and compensation committees of boards of directors can play a meaningful role in ensuring that entities identify and attract competent and ethical members of the board and senior management–the right people in the right environment–and ensuring fair and transparent compensation policies.

- Boards of directors, including audit committees, work for the shareholders and should have appropriate job qualifications, independence, and resources to be able to do their job effectively.

- Consideration needs to be given to matters such as (1) what type of relationship the board should have with management (for example, constructive engagement), and (2) what, if any, selection process changes are necessary in order to assure the proper identification of qualified and independent board members.

- The mutual funds industry might be a good model for defining the expertise needed for audit committee membership, as well as for nominations and compensation committees.

- Increasing demands regarding expertise and potential liability concerns could limit the number of potential committee candidates. However, there is a vast pool of more senior, former corporate executives and public accounting profession members that could serve as potential committee members (e.g., early retirees).

- Audit committees are not in a position to manage the audit process and, thus, may not be in the best position to hire the auditors. However, audit committees can serve as a buffer between the external auditors and company management, which hires the auditors.

- Audit committees would be most effective if they (1) are comprised of highly qualified individuals who are truly independent of top management, (2) meet periodically (e.g., quarterly) with both external and internal auditors without entity management present, and (3) have their own counsel and other resources. Audit committees need to ensure that there is an effective internal audit function, effective internal controls, and an appropriate code of conduct, and they need to invest time in researching the entity and asking the right questions.

- Consideration might be given to creating more independent, whistle-blowing mechanisms within entities, such as establishing chief ethics officers or ombudsmen. It may make sense to model such a mechanism in part on the current federal inspector general concept. Here again, there is a large pool of highly qualified early retirees who could fill such positions.

Oversight

Forum participants identified the following key issues related to oversight.

- Capital markets and investors rely on entities to report timely and reliable financial information and to provide reasonable disclosure to understand related risks.

- Effective oversight will not necessarily prevent entities from making bad business decisions and from failing. Oversight can, however, help to ensure that investors adequately understand related risks; that financial performance is measured in a timely, accurate, and reasonably consistent manner; and that conflicts of interest are identified and properly dealt with.

- A more direct government role in accounting and auditing standards setting and other intervention may not necessarily improve oversight, particularly when taking into account the knowledge and expertise needed to address conflicts of interest and increasingly complex financial issues. It may be more effective in the long run for regulators to require stronger self-regulatory measures, to aggressively oversee those measures, and to take more timely and meaningful civil and criminal enforcement actions when rules are violated.

- Many entities today are taking a closer look at their own governance and risks in light of recent high profile business failures. Disclosure of how they address key governance issues, in the form of asking questions or adopting best practices, may be more effective than placing undue reliance on severe enforcement mechanisms, such as delisting companies.

- There may be merit in considering more rigorous requirements and/or restrictions for larger companies, such as those listed on the major exchanges. In such instances, though, investors should know fully about any differing requirements.

Where Do We Go From Here

The forum participants identified the following ideas for possible follow-up.

- Efforts by GAO and other organizations to identify possible common denominators for major business failures might identify other specific issues, particularly those related to potential conflicts of interest and inadequate disclosures.

- Best practices guides in connection with certain important areas (e.g., audit committees) could be beneficial in helping to enhance the effectiveness of the related parties.

- Roundtable discussions with members of specific groups, such as audit committee members or internal auditors, might help to identify other specific issues related to corporate governance, transparency, and accountability.

- The issues identified in this forum should be periodically revisited by these participants or by others. For example, this group should consider meeting again in one year to review and assess progress and determine what, if any, additional actions may be appropriate.

Appendix II

GAO's Corporate Governance, Transparency, and Accountability Forum

Participants

Charles A. Bowsher	Chair, Public Oversight Board; and Former Comptroller General of the United States
William E. Brock	Former Secretary, U.S. Department of Labor
Robert C. Butler	Former Chair, Financial Accounting Standards Advisory Council
James G. Castellano	Chair, American Institute of Certified Public Accountants
James Cochrane	Senior Vice President, Strategy and Planning, New York Stock Exchange
Michael J. Cook	Retired Chairman and Chief Executive Officer Deloitte & Touche LLP
Mark W. Everson	Controller, Office of Management and Budget
Kayla J. Gillan	General Counsel, CalPERS
Christina Gold	Vice Chair, The Conference Board
Barbara Hafer	President, National Association of State Auditors, Comptrollers, and Treasurers
Robert K. Herdman	Chief Accountant, Securities and Exchange Commission
Edmund L. Jenkins	Chair, Financial Accounting Standards Board
Marc Lackritz	President, Securities Industry Association
Philip B. Livingston	President, Financial Executives International
Barry C. Melancon	President, American Institute of Certified Public Accountants
Robert A. G. Monks	Founder, Institutional Shareholder Services; and Former Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor

David Mosso	Chair, Financial Accounting Standards Advisory Board
John F. Olson	Chair, ABA Committee on Corporate Governance
Stephen C. Patrick	CFO, The Colgate-Palmolive Company
Gary J. Previts	Chair, Global Communications Committee of the International Association of the Financial Executives Institute
Roger W. Raber	President, National Association of Corporate Directors
David S. Ruder	Former Chair, Securities and Exchange Commission
Mary L. Schapiro	President, NASD Regulation; and Former Chair, CFTC
David Shedlarz	Executive Vice President and CFO, Pfizer Inc.
A.W. Pete Smith	President and CEO, Private Sector Council
Stanley Sporkin	Former Director of Enforcement, SEC; and Former Federal District Court Judge
Elmer B. Staats	Former Comptroller General of the United States
Mark J. Ugoretz	President, ERISA Industry Committee

Appendix III

GAO's Corporate Governance, Transparency, and Accountability Forum

Possible Questions for Discussion

GENERAL:

- What steps need to be taken to minimize the possibility that another rapid and unexpected decline and fall of a major public company and related pension plans, like the Enron situation, will occur?
- What types of systemic issues need to be reviewed and considered (e.g., accounting/reporting, auditing, corporate governance, pensions, self-regulatory, legislative, regulatory, enforcement)?

ACCOUNTING/REPORTING:

- Do the current accounting/reporting and SEC disclosure models provide meaningful, timely and useful information for investors and other key stakeholders to make informed decisions?
- Are there significant items of value that the current accounting and reporting model does not adequately address?
- Are there significant liabilities, commitments, contingencies or other risk related items that the current accounting and reporting model does not adequately address (e.g., special purpose entities, uncovered arbitrage positions)?
- Is there a need for enhanced key trend or projection information in corporate financial statements?
- What should be the minimum standards for "pro-forma" financial information reported by public companies?
- How does the Internet (e.g., company web site information) affect the current accounting and reporting model?

AUDITING:

- Are there significant items of value or risk that the current audit model does not adequately address?
- Does the current approach to testing and reporting on internal controls make sense?
- Does the current audit framework relating to fraud make sense?
- What type of relationship should the outside auditor have with management?
- What type of relationship should the outside auditor have with the Board and the Audit Committee?
- Are the current disciplinary mechanisms in place for auditors adequate and effective?
- What, if any, changes need to be made to the current peer review model?
- What, if any, changes in the current auditor independence rules should be made?
- How does the Internet (e.g., company web site information) affect the current audit model?

CORPORATE GOVERNANCE:

- Should CEO's also serve as Chairman of the Board in public companies?
- Who should select Board candidates for voting on by the shareholders?
- What, if any, minimum qualification requirements should be imposed on public company board and audit committee members?
- Should there be additional restrictions on the number of inside directors for public companies?
- What, if any, changes should be made to the role and structure of audit committees (e.g., revisions to independence definitions, limitations on compensation levels/methods and/or rotation of members)?
- How can the Board and the outside auditors work together to enhance shareholder value and better address shareholder risks, including the overall control environment?

PENSIONS:

- What, if any, additional restrictions should be considered or additional guidance is needed in connection with plan investments in employer securities? How might these vary by type of plan (e.g., 401(k) plans versus ESOPs)?
- What, if any, modifications in regulatory or enforcement approaches should be considered in connection with plan investments in employer securities?
- What, if any, changes should be considered in connection with plan freezes of investment elections due to changes in plan service providers (e.g., plan recordkeeper)?

OVERSIGHT:

- What is your reaction to Chairman Pitt's proposal of new oversight bodies for the accounting profession?
- What, if any, changes need to be made in the current review and oversight models to identify possible cases like Enron before they occur in addition to conducting post-mortems?
- How can the coordinated and integration of the current multi-faceted and multi-dimensional oversight model be improved?
- Does the POB have adequate authority and resources to effectively discharge its audit oversight responsibilities?
- Does the SEC have adequate authority and resources to effectively discharge its reporting, regulatory and enforcement responsibilities?
- Does the DOL have adequate authority and resources to effectively discharge its pension oversight responsibilities?
- Does the AICPA have adequate authority and resources to effectively discharge all of its professional governance responsibilities (e.g., standards, monitoring, disciplinary actions)?

OTHER:

- What, if any, changes should be made in connection with conflict of interest rules for corporate management?
- What, if any, revisions or restrictions should be made in connection with insider trading?
- What, if any, changes are necessary in connection with the role and function of securities analysts?
- What, if any, other related systemic issues should be discussed?

BusinessWeek

Business Week

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HEADLINE: CAN THE SEC HANDLE ALL THIS SCANDAL?

BYLINE: By Mike McNamee, with Amy Borrus, in Washington

HIGHLIGHT:
Its chief enforcer faces a swelling caseload and a frozen budget

BODY:
The first chairman of the Securities & Exchange Commission, William O. Douglas, once said that the agency should always keep "a well-oiled shotgun in the corner" to use on miscreants. Douglas' embattled 25th successor, Harvey L. Pitt, has more reason than most to remember that. For Pitt, Stephen M. Cutler is that shotgun.

As director of the SEC's Enforcement Div., Cutler is the top cop on what's now Washington's highest-profile beat. But his toughest task isn't just catching those responsible for such high-profile financial failures as Enron Corp. and Global Crossing Ltd. Cutler also has to convince skeptical investors and hang-'em-high lawmakers that the SEC can restore confidence in Corporate America. That means overcoming the strong impression -- created by Pitt's stumbling start and the Bush White House's stinginess -- that his bosses would rather let the SEC's shotgun rust. Is Cutler up to that job? The 41-year-old lawyer is far more of a crusader than his boss: After graduating from Yale Law School, Cutler spent a year working with Bill Lann Lee, who later headed the Justice Dept.'s Civil Rights Div. under Bill Clinton. Those who have come up against him say Cutler, who assumed the top job in October after three years as deputy, is a daunting strategist. "You don't face off with Steve Cutler -- it's more like a chess match," says Ralph C. Ferrara of Debevoise & Plimpton, who defended MicroStrategy Inc. in 2000 when the SEC collected $ 11 million in penalties and restitution from execs of the McLean (Va.) software company for using aggressive accounting. Ferrara adds: "You won't get a lot of table-pounding from Steve -- but you will see a lot of sanctions against people who violated the law."

The sorry state of accounting is Cutler's priority. In the first eight weeks of 2002, Enforcement has launched accounting inquiries into 45 companies, a 165% jump in a caseload that has been rising since 1998. Post-Enron, "we're getting lots of cards and letters, and more of them from people with firsthand knowledge of misconduct," Cutler says.

But to turn tips into fines and penalties, Cutler needs resources and backing -- and the picture is worrisome on both fronts. The Bush Administration froze the SEC's 2003 budget -- which Pitt O.K.'d. The chairman won't say if he'll ask Congress for more. For this year, Cutler sees no increase in his team of 775 lawyers, accountants, and market-watchers despite the growing caseload. "We're stretched thin," he says.

Pitt's rhetoric hasn't helped. After a career defending accountants, brokers, and executives against SEC charges, Pitt launched his tenure with a speech promising accountants a "kinder and gentler" SEC than under his predecessor, Arthur Levitt Jr. Then came an SEC report spelling out how companies with bookkeeping woes that turn themselves in might win lighter penalties. And Pitt has been slow to respond to Enron Corp. "In most corporate scandals, the SEC chairman is the drum major in front of the reform parade," says John C. Coffee Jr., a securities law professor at Columbia University. "This time, the band marched over the drum major, and he's had to catch up with the parade."

Pitt talks a lot tougher now. He wants "real-time enforcement," he says, forcing companies to restate their books sooner and speeding cases. The chairman also wants harsher penalties. He would strip executives of bonuses and option rewards that were based on inflated stock prices. And the SEC is calling in the Justice Dept. to seek criminal charges on more cases: "Nothing speaks as loudly to Corporate America as the prospect of jail time," Cutler says. The agency also wants more power to bar offenders from serving as officers or directors of public companies.

Still, Pitt's main tool for restoring the SEC's credibility is Cutler, who has free rein to investigate Enron, Global Crossing, and their auditor, Arthur Andersen. "I've told my staff, 'We've got to bring a tough prosecutorial attitude, but also a sense of justice,'" Cutler says. A few more shells for his shotgun wouldn't hurt, either.

THE WALL STREET JOURNAL. ONLINE

February 25, 2002

MANAGER'S JOURNAL
COLLIN LEVEY, EDITOR

FROM THE ARCHIVES: February 25, 2002

Listing in a Material World

By ANDY KESSLER

We don't need no stinkin' Congressional hearings. This whole accounting mess can be cleared up by simply defining the word *materiality*.

Have you ever tried driving your car by only looking in the rearview mirror? That is exactly what it is like being an investor. You study the past to reveal hints of the twists and turns of the road ahead. Oh yeah, and it's foggy in front of you and your passenger seat is filled with analysts and industry sources and newspaper reporters and talking heads yelling often conflicting advice on where to turn.

Jeffrey Immelt

The best information on a company comes from the company itself, in the form of quarterly disclosures, which investors use to figure out ongoing business trends vs. one-time events. But management guided by accountants hides behind the vague meaning of "materiality," or what actually has to be disclosed.

The margin of materiality was first used to cover honest mistakes by accountants. As in: "Oh, we missed counting a few widgets, but it's not a material enough amount to bother correcting." But what is considered material? No one knows. In the past, the Securities and Exchange Commission has gone by the scientific definition of materiality as something that someone somewhere might consider important.

In 1998, the Financial Accounting Standards Board got more specific. Something was material when it was big enough that "the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement," it said. Accountants use a rule of thumb that something larger than 5% or 10% is material. But 5% to 10% of what? Revenue? Assets? Profits?

As an investor, whenever I asked a CEO for more details on the last quarter, a further

RECENT COLUMNS

ABOUT THE MANAGER'S JOURNAL

Manager's Journal is a weekly column that analyzes a business issue or story or, occasionally, a management issue or story involving a nonbusiness enterprise such as a government agency or a nonprofit organization.

Some Manager's Journals are written in the first person by a CEO or other manager; others are written by reporters, analysts or consultants. The column, which runs on Mondays, is edited by Collin Levey.

breakdown of revenues, prices, or who's buying a hot new product, I was usually told the details were not material, meaning they were less than 10% of current revenues, even though that hot product might soon be half of the company's business. The next favorite response was that management couldn't tell me for "competitive reasons."

I always felt like saying, "Look pal, I'm an owner of your company. I'm trying to make a decision whether to buy more shares, which would push up your stock price, allow you to raise cheaper capital, employ more option-hungry engineers, so you can kill your competitors, who told me about this hot product in the first place."

But, like Enron, many companies held back disclosures by hiding behind materiality thresholds. As a $100 billion company, anything less than $10 billion at Enron was not considered material.

As an investor, flying blind, I want to know everything you can tell me. Don't tell me it would be information overload, I have spreadsheets, I can handle it. Plus there are thousands of Wall Street analysts with not much to do who will gladly pour through these details and form an opinion.

A few weeks ago, Tyco got around to mentioning it did over 700 acquisitions totaling $7 billion in 1999-2001, $4 billion just last year, and the stock promptly halved. They may have been 700 of the greatest companies, but to paraphrase Dr. Strangelove, "The whole point is lost if you keep it a secret. Why didn't you tell the world, eh?"

Global Crossing got snagged doing capacity swaps on the last day of the quarter, which boosted reported revenues, but not much else. These swaps of Indefeasible Rights of Use (IRUs) were disclosed, as they totaled almost 25% of revenues in Global Crossing's last quarter before filing Chapter 11. But no other details were given. And the company invented an adjusted cash flow to report to investors. Guess which way it was adjusted.

OK, so Enron, Tyco, Global Crossing -- maybe those guys were just a bunch of cowboys. Real companies disclose, right?

Not really. The bluest of the blue chips is IBM and it just got lost in the Sea of Materiality as well. IBM sold an optical component division to JDS Uniphase for a $300 million gain. But rather than reporting it as a one-time gain, IBM used it as an offset to lower its expenses, so it magically flew under the radar. IBM's revenues in the last quarter were $22 billion, so $300 million is noise. But after-tax profits were $1.3 billion, which investors assumed represented an ongoing trend. Three hundred million dollars in hidden expense reductions means profits were legally overstated by up to 20%. By management refusing to ratchet down the materiality dial, investors were duped. Is this the Lou Gerstner legacy?

As an "average prudent investor," to borrow the SEC's lingo, I hereby declare that for me to be reasonably informed the materiality threshold should be 1%. While SEC chief Harvey Pitt now wants more oversight for accountants, all we need to do is recommend companies use 1% materiality. And make it voluntary.

When a company releases earnings, it should be required to include its materiality threshold. Want to stay at 10%? Fine, just tell me. Oh, your stock may trade at a lower earnings multiple, though, since no one can trust your earnings. Want to claim a 1% materiality threshold? Great, but you better back it up with all sorts of details on how revenues break down, prices, large customers and so on.

General Electric's stock is down 30% from its May 2001 peak, because investors are worried that the House That Jack Built is increasingly a giant hedge fund with unknown risks. GE Capital, after all, is 40% of its business. In response to investor concerns, CEO Jeffrey Immelt

now plans to provide sales and earnings details on 14 financial business units. That feels like a 3% disclosure. Every company in the S&P 500 should follow suit.

Don't have that much detail at hand about your own company? I'd get your numbers-crunchers on it real quick. If you don't want to disclose information, stay private, and try borrowing money from your local bank.

Mr. Kessler, a former hedge-fund manager, is writing a book on technology and markets.

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http://online.wsj.com/article/0,,SB1014593680928693280.djm,00.html

Updated February 25, 2002

February 25, 2002, Monday, Section A; Page 20, Column 4, 59 words, LISTING IN A MATERIAL WORLD, BY ANDY KESSLER

GAO
Accountability • Integrity • Reliability

Comptroller General
of the United States

United States General Accounting Office
Washington, DC 20548

May 3, 2002

The Honorable Paul S. Sarbanes
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

This letter responds to your recent request that we provide our views regarding what steps the Congress should consider taking to strengthen oversight of the accounting profession, auditor independence, and selected financial reporting matters. The sudden and largely unexpected bankruptcy of the Enron Corporation (Enron) and other large corporations' financial reporting restatements have raised questions about the soundness of the current self-regulatory and financial reporting systems and resulted in substantial losses to employees, shareholders, and other investors. These events have also raised a range of questions regarding how such dramatic and unexpected events can happen and the role and capacities of various key players under the existing systems.

The issues surrounding the accounting profession's current self-regulatory system for auditors involves many players in a fragmented system that is not well coordinated, involves certain conflicts of interest, lacks effective communication, has a funding mechanism that is dependent upon voluntary contributions from the accounting profession, and has a discipline system that is largely perceived as being ineffective. (Enclosure 1 serves to illustrate the complexity of the current system of regulation and oversight and the stakeholders who rely on the system.)

Simply stated, the current self-regulatory system is broken and oversight of the self-regulatory system by the Securities and Exchange Commission (SEC) has not been effective in addressing these issues to adequately protect the public interest. As a result, given the important role that independent auditors play and various inherent problems in the current self-regulatory system, direct government intervention is needed to statutorily create a new body to oversee the accounting profession's responsibilities for auditing public companies. This step is necessary in order to increase the effectiveness of the audit process and to rebuild public confidence. The new body should be independent of the accounting profession, have significant standards-setting, oversight, and disciplinary authority, be adequately resourced to fulfill its responsibilities, and have sufficient operating flexibility to attract and retain quality leadership and supporting staff.

On the other hand, the concerns relating to the timeliness, relevancy and transparency of the financial reporting model may be best addressed through the SEC working more closely with the Financial Accounting Standards Board (FASB), assuring that the FASB has an adequate and independent source of funding for its operations, and reporting periodically to the Congress in connection with certain FASB matters. If such an approach is not successful in achieving the expected improvements in the financial reporting model in a timely and effective manner, the government can then take further action.

The areas of oversight of the accounting profession, auditor independence, and financial reporting are important on their own, but they also represent interrelated keystones to protecting the public's interest. Failure in any of these areas can place a strain on the entire system. Consequently, potential actions should be guided by the fundamental principles of having the right incentives for the key parties to do the right thing, adequate transparency to provide reasonable assurance that the right thing will be done, and full accountability if the right thing is not done. These three fundamental principles represent a system of controls that should operate in conjunction with a policy of placing special attention on areas of greatest risk.

NEW BODY NEEDED TO REGULATE AND OVERSEE THE ACCOUNTING PROFESSION

Enron's failure and a variety of other recent events have brought a direct focus on the ineffectiveness of the current system of regulation and oversight of the accounting profession. Independent auditors have a key role to play in protecting shareholders and the public's interest in our capital market system. They hold a public trust and their actions or inactions can have significant implications on investors, creditors and other users of financial reports. In this regard, auditors must place additional emphasis on whether financial statements are "fairly presented in all material respects" in addition to their traditional emphasis on whether such financial statements are prepared "in accordance with generally accepted accounting principles." Fair presentation requires providing reasonable assurance that major value and risk elements are appropriately reflected in the financial statements and related notes in an understandable fashion. It also requires employing an "economic substance" versus "transaction form" approach to important accounting and reporting issues.

Many proposals are before the Congress to establish a new body to regulate and/or oversee accounting firms that audit public companies. In our view, the Congress should consider the following key factors or criteria in establishing this new body, each of which is critical to its likely effectiveness.

Functions of the New Body

The new body should have direct responsibility and authority for certain critical functions in connection with public accounting firms and their members who audit public companies. These include:

- establishing professional standards (independence standards; quality control standards, auditing standards, and attestation standards). The new body should be authorized to issue professional standards. In that respect, the new body should also be authorized to affirmatively adopt, at its discretion, professional standards, in whole or in part, promulgated by another standard-setting body. In the area of new standards, the new body may choose to require auditor reporting on the effectiveness of internal control over financial reporting in connection with audits of public companies, which is currently not required under existing auditing standards. It may also decide not to affirmatively adopt a standard developed by another standard-setting body but instead issue a modified version of the standard.

- monitoring public accounting firms for compliance with applicable professional standards. For efficiency, except for quality reviews of the largest firms and those firms in which the nature of the audits they perform pose a higher level of risk as determined by the new body, the new body should be authorized to use contractors or accounting firms to perform quality reviews in accordance with standards and processes set by the new body. However, the new body should have final approval authority in connection with any quality review engagements performed by any contractors or accounting firms.

- investigating and disciplining public accounting firms and/or individual auditors of public accounting firms who do not comply with applicable professional standards. Investigations and disciplinary actions of the new body should be in addition to existing investigatory and disciplinary authority that already exists with the SEC and state boards of accountancy.

- establishing various auditor rotation requirements for key public company audit engagement personnel (i.e., primary and second partners, and engagement managers). Related to this function, we believe the new body should undertake a study and report to the Congress on the pros and cons of any mandatory rotation of accounting firms that audit public companies before taking any action with regard to establishing requirements for any mandatory rotation of accounting firms.

Funding for the New Body

The new body should have independent sources of funding by virtue of mandatory, not voluntary, payments. Public accounting firms and audit partners that audit financial statements, reports, or other documents of public companies that are required to be filed with the SEC should be required to register with the new body. The new body should have the authority to set annual registration fees and fees for

services such as peer reviews of public accounting firms. The fees should be set to recover full costs and sustain the operations of the new body.

Reporting Requirement of the New Body
and GAO Access to Records

The new body should report annually to the Congress and the public on the full range of its activities, including coordination with other standard-setting bodies whose standards it so chooses to adopt, setting professional standards, peer reviews of public accounting firms, and related disciplinary activities. Such reporting also provides the opportunity for the Congress to conduct oversight of the performance of the new body. The Congress also may wish to have GAO review and report on the performance of the new body after the first year of its operations and periodically thereafter. Accordingly, we suggest that the Congress provide GAO not only access to the records of the new body, but also access to the records of other entities that the new body has chosen to rely on, such as other standard-setting bodies, and contractors or public accounting firms that conduct quality reviews, to the extent GAO considers necessary to assess the performance of the new body.

Structure of the New Body

The new body should be created by statute and should be independent of the accounting profession. To facilitate operating independently, the new body's board members should be highly qualified and should have authority to set and approve its operating rules. The new body should have independent decision-making authority; however, it should coordinate and communicate its activities with other parties such as the SEC, the various state boards of accountancy, other standard- setters, and GAO, as appropriate. The new body should set its own human resource and other administrative requirements and should be given appropriate flexibility to provide compensation that is competitive to attract highly competent board members and supporting staff. The new body should also have adequate staff to effectively discharge its responsibilities.

Candidates for the new body's board membership could be identified through a nominating committee that could include the Chairman of the Federal Reserve, Chairman of the SEC, the Secretary of the Treasury, and the Comptroller General of the United States. This approach would help to assure the qualifications and independence of all board members.

The number of board members could be 5 or 7 and have stated terms, such as 5 years with a limited renewal option, and the members' initial terms should be staggered to ensure some continuity. Ideally, the members of the board should be presidential appointees who are confirmed by the Senate (PASs). However, if the board members are not PASs, the board should be actively overseen by and accountable to a body that is composed of PASs, such as the SEC, in order to assure adequate accountability to the Congress and the public. At a minimum, the chair and vice-chair should serve on a full-time basis. None of the board members should be active

accounting profession practitioners, and a majority of board members should not have been accounting profession practitioners within the recent past (e.g., 3 years).

There are several alternative structures that the Congress could choose from in establishing the new body, including creating (1) a new unit within the SEC, (2) an independent government entity within the SEC, (3) an independent government agency outside the SEC, or (4) a non-governmental private-sector entity overseen by the SEC. Each of the above alternative structures have various pros and cons that should be considered in order to assure the credibility and effectiveness of the new body in protecting the public interest. We believe that each of the alternative structures provides an organizational foundation for managing and operating the new body that potentially is workable. For the following reasons, we favor alternatives two and three and believe they have a greater likelihood of success.

Under alternatives one and four, the new body's functions (e.g., establishing professional standards, monitoring, and discipline) would be subject to SEC approval in order to assure that all actions are in the public's interest and appropriate accountability to the Congress and the public. This, however, would increase the SEC's responsibility as well as its workload, for the agency and the Commissioners, both of which are already overloaded. Also, under alternatives one and four the new body's board members would not likely be PASs since under alternative one the SEC Chair and other Commissioners are PASs, and since alternative four involves a non-governmental entity. Therefore, under alternatives one and four, the new body would have less direct accountability to the Congress and the public than a body with board members who are PASs. This limitation could be mitigated to some extent by ensuring that regardless of the structure of the new body that board members are selected from candidates provided by an independent and appropriately qualified nominating committee as previously discussed.

Although a structure that provides direct accountability to the Congress and the public is important in our view, a more critical question regarding the structure of alternatives one and four is whether the SEC has the capacity to effectively take on such an additional workload. Clearly, the SEC has the culture and potential to perform an active oversight role and this would be in line with its current mission. But, does it realistically have the capacity to do so? From a historical perspective, while the SEC has had authority for over 70 years to regulate the public accounting profession under the federal securities laws and regulations related to public companies, it has largely relied on the public accounting profession to regulate itself. It is now apparent that this model has not adequately protected the public's interest. Therefore, the SEC would need to institute a new function within its organization, as called for in alternative one, or a new oversight structure for a private-sector entity outside the SEC, as called for in alternative four, both of which would require additional resources and a significant increase in priority to more directly regulate the accounting profession at a time when the SEC is already facing a range of challenges in fulfilling its current responsibilities. Further, we believe that the SEC also needs to increase the amount of time and attention that it allocates to interacting with the FASB, the stock exchanges, and the investment banking/analyst community.

As we recently reported,[1] the SEC's ability to fulfill its mission has become increasingly strained due, in part, to significant imbalances between the SEC's workload (such as filings, complaints, inquiries, investigations, examinations, and inspections) and staff resources. Although additional resources could help the SEC do more, additional resources alone would not help the SEC address its high staff turnover, which continues to be a major challenge for the agency. About 40 percent of the SEC's staff left the agency between 1998 and 2001 and, as a result, the average level of experience at the SEC has been declining. For example, in 2000, 76 percent of the SEC's examiners had been with the agency less than 3 years. However, we also reported that the SEC has not made effective use of strategic planning and information technology to leverage its limited resources. In addition to putting more strain on the SEC's capacity, alternatives one and four would also likely be less efficient models for the new body to operate under by requiring additional time and attention from the SEC.

Alternative two, which calls for the creation of an independent government entity within the SEC, and alternative three, which calls for the creation of an independent government agency outside the SEC, do not pose the same capacity challenges for the SEC, especially at the Commissioner level, as alternatives one and four. Also, alternatives two and three both meet each of the critical factors outlined above for the structure of the new body. We recognize there may be concern over adding more political appointments that have to be Senate confirmed, as called for under alternatives two and three, given the recent challenges of filling positions that are PASs. However, having an independent entity overseen by PASs serves to significantly enhance the entity's accountability to the Congress and the public.

Of these two alternatives, we favor alternative two as having a greater likelihood of success because the new body would be housed within the SEC and, therefore, could receive administrative support from the SEC, including human resources, payroll, and other administrative support. More importantly, this alternative should better facilitate communication and provide for maximum coordination with the SEC, while also allowing the new body the independence to design its own policies and procedures and systems as it deemed appropriate. In addition, alternative two would not require the Congress to create a separate federal entity. Alternative two would also facilitate a consolidation of the new entity under the SEC in future years if such a consolidation was deemed to be both desirable and appropriate. Therefore, we believe that alternative two has the greatest likelihood of success in terms of potential effectiveness, efficiency, and accountability of the new body. However, as previously stated, each of the alternative structures has merit and can potentially work if properly designed and implemented.

AUDITOR INDEPENDENCE

For over 70 years, the public accounting profession, through its independent audit function, has played a critical role in enhancing a financial reporting process that has

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[1] *SEC Operations: Increased Workload Creates Challenges*, (GAO-02-302, March 5, 2002).

supported the effective functioning of our domestic capital markets, which are widely viewed as the best in the world. The public's confidence in the reliability of issuers' financial statements, which relies in large part on the role of independent auditors, serves to encourage investment in securities issued by public companies. This sense of confidence depends on reasonable investors perceiving auditors as independent expert professionals who have neither mutual, nor conflicts of, interests in connection with the entities they are auditing. Accordingly, investors and other users expect auditors to bring to the financial reporting process integrity, independence, objectivity, and technical competence, and to prevent the issuance of misleading financial statements.

Enron's failure and certain other recent events have raised questions concerning whether auditors are living up to the expectations of the investing public; however, similar questions have been raised over a number of years due to significant restatements of financial statements and certain unexpected and costly business failures, such as the savings and loan crisis. Issues debated over the years continue to focus on auditor independence concerns and the auditor's role and responsibilities. Public accounting firms providing nonaudit services to their audit client is one of the issues that has again surfaced by Enron's failure and the large amount of annual fees collected by Enron's independent auditor for nonaudit services.

Auditors have the capability of performing a range of valuable services for their clients, and providing certain nonaudit services can ultimately be beneficial to investors and other interested parties. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, the client, or both will have to make a choice as to which of these services the auditor will provide. These concepts, which we strongly believe are in the public's interest, are reflected in the revisions to auditor independence requirements for government audits,[2] which GAO recently issued as part of *Government Auditing Standards*.[3] The new independence standard has gone through an extensive deliberative process over several years, including extensive public comments and input from my Advisory Council on Government Auditing Standards.[4] The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The two overarching principles in the standard for nonaudit services are that:

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[2] *Government Auditing Standards: Amendment No. 3, Independence* (GAO-02-388G, January 2002).

[3] *Government Auditing Standards* was first published in 1972 and is commonly referred to as the "Yellow Book," and covers federal entities and those organizations receiving federal funds. Various laws require compliance with the standards in connection with audits of federal entities and funds. Furthermore, many states and local governments and other entities, both domestically and internationally, have voluntarily adopted these standards.

[4] The Advisory Council includes 20 experts in financial and performance auditing and reporting drawn from all levels of government, academia, private enterprise, and public accounting, who advise the Comptroller General on *Government Auditing Standards*.

- auditors should not perform management functions or make management decisions, and

- auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

Both of the above principles should be applied using a substance over form doctrine. Under the revised standard, auditors are allowed to perform certain nonaudit services provided the services do not violate the above principles; however, in most circumstances certain additional safeguards would have to be met. For example, (1) personnel who perform allowable nonaudit services would be precluded from performing any related audit work, (2) the auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work were performed by another unrelated party, and (3) certain documentation and quality assurance requirements must be met. The new standard includes an express prohibition regarding auditors providing certain bookkeeping or record keeping services and limits payroll processing and certain other services, all of which are presently permitted under current independence rules of the AICPA. However, our new standard allows the auditor to provide routine advice and technical assistance on an ongoing basis and without being subject to the additional safeguards.

The focus of these changes to the government auditing standards is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities and entities that receive federal funding. However, these standards apply only to audits of federal entities and those organizations receiving federal funds, and not to audits of public companies. In the transmittal letter issuing the new independence standard, we expressed our hope that the AICPA would raise its independence standards to those contained in this new standard in order to eliminate any inconsistency between this standard and their current standards. The AICPA's recent statement before another congressional committee that the AICPA will not oppose prohibitions on auditors providing certain nonaudit services seems to be a step in the right direction.[5]

The independence of public accountants is crucial to the credibility of financial reporting and, in turn, the capital formation process. Auditor independence standards require that the audit organization and the auditor be independent both in fact and in appearance. These standards place responsibility on the auditor and the audit organization to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as being impartial by knowledgeable third parties. Because independence standards are fundamental to the independent audit function, as part of its mission, the new statutorily created body, which we previously discussed, should be responsible for setting independence standards for audits of public companies, as well as have the

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[5] Testimony of AICPA Chairman before the House Energy and Commerce Committee (Subcommittee on Communications, Trade and Consumer Protection), February 14, 2002.

authority to discipline members of the accounting profession that violate such standards.

FINANCIAL REPORTING

Business financial reporting is critical in promoting an effective allocation of capital among companies. Financial statements, which are at the center of present-day business reporting, must be timely, relevant, and reliable to be useful for decision-making. In our 1996 report on the accounting profession,[6] we reported that the current financial reporting model does not fully meet users' needs. More recently, we have noted that the current reporting model is not well suited to identify and report on key value and risk elements inherent in our 21st Century knowledge-based economy. The SEC is the primary federal agency currently involved in accounting and auditing requirements for publicly traded companies but has traditionally relied on the private sector for setting standards for financial reporting and independent audits, retaining a largely oversight role. Accordingly, the SEC has accepted rules set by the FASB—generally accepted accounting principles (GAAP)—as the primary standard for preparation of financial statements in the private sector.

We found that despite the continuing efforts of FASB and the SEC to enhance financial reporting, changes in the business environment, such as the growth in information technology, new types of relationships between companies, and the increasing use of complex business transactions and financial instruments, constantly threaten the relevance of financial statements and pose a formidable challenge for standard setters. A basic limitation of the model is that financial statements present the business entity's financial position and results of its operations largely on the basis of historical costs, which do not fully meet the broad range of user needs for financial information.[7] Enron's failure and the inquiries that have followed have raised many of the same issues about the adequacy of the current financial reporting model, such as the need for additional transparency, clarity, more timely information, and risk-oriented financial reporting.

Among other actions to address the Enron-specific accounting issues, the SEC has requested that the FASB address the specific accounting rules related to Enron's special purpose entities and related party disclosures. In addition, the SEC Chief Accountant has also raised concerns that the current standard-setting process is too cumbersome and slow and that much of the FASB's guidance is rule-based and too

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[6] *The Accounting Profession: Major Issues: Progress and Concerns* (GAO/AIMD-96-98, September 24, 1996).

[7] The accounting and reporting model under generally accepted accounting principles is actually a mixed-attribute model. Although most transactions and balances are measured on the basis of historical cost, which is the amount of cash or its equivalent originally paid to acquire an asset, certain assets and liabilities are reported at current values either in the financial statements or related notes. For example, certain investments in debt and equity securities are currently reported at fair value, receivables are reported at net realizable value, and inventories are reported at the lower of cost or market value. Further, certain industries such as brokerage houses and mutual funds prepare financial statements on a fair value basis.

complex. He believes that (1) a principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues, (2) the FASB needs to be more responsive to accounting standards problems identified by the SEC, and (3) the SEC needs to give the FASB freedom to address the problems, but the SEC needs to monitor projects on an ongoing basis and, if they are languishing, determine why.

We generally agree with the SEC Chief Accountant's assessment. We also believe that the issues surrounding the financial reporting model can be effectively addressed by the SEC, in conjunction with the FASB, without statutorily changing the standard-setting process. However, we do believe that a more active and ongoing interaction between the SEC and the FASB is needed to facilitate a mutual understanding of priorities for standard-setting, realistic goals for achieving expectations, and timely actions to address issues that arise when expectations are not likely to be met. In that regard, the SEC could be directed to:

- reach agreement with the FASB on its standard-setting agenda, approach to resolving accounting issues, and timing for completion of projects;

- monitor the FASB's progress on projects, including taking appropriate actions to resolve issues when projects are not meeting expectations; and

- report annually to the Congress on the FASB's progress in setting standards, along with any recommendations, and the FASB's response to the SEC's recommendations.

The Congress may wish to have GAO evaluate and report to it one year after enactment of legislation and periodically thereafter on the SEC's performance in working with the FASB to improve the timeliness and effectiveness of the accounting standard-setting process. Accordingly, we suggest that the Congress provide GAO access to the records of the FASB that GAO considers necessary for it to evaluate the SEC's performance in working with the FASB.

The FASB receives about two-thirds of its funding from the sale of publications with the remainder of its funding coming voluntarily from the accounting profession, industry sources, and others. One of the responsibilities of the FASB's parent organization, the Financial Accounting Foundation, is to raise funds for the FASB and its standard-setting process to supplement the funding that comes from the FASB's sale of publications. Some have questioned whether this is the best arrangement to ensure the independence of the standard-setting process. This issue has been raised by the appropriateness of certain accounting standards related to consolidations, that the FASB has been working on for some time, applicable to Enron's restatement of its financial statements as reported to the SEC by Enron in its November 8, 2001, Form 8-K filing. However, the issue has previously been raised when the FASB has addressed other controversial accounting issues, such as accounting for stock options. We believe that the FASB should have mandatory sources of funding to remove the appearance of any independence issues related to funding FASB. Therefore, the Congress may wish to task the SEC with studying this issue and

identifying alternative sources of mandatory funding to supplement the FASB's sale of publications, including the possibility of imposing fees on registrants and/or firms, and to report to the Congress on its findings and actions taken to address the funding issue.

CLOSING COMMENTS

The United States has the largest and most respected capital markets in the world. Our capital markets have long enjoyed a reputation of integrity that promotes investor confidence. This is critical to our economy and the economies of other nations given the globalization of commerce. However, this long-standing reputation is now being challenged by some parties. The effectiveness of systems relating to independent audits and financial reporting which represent key underpinnings of capital markets and are critical to protecting the public's interest, has been called into question by the failure of Enron and certain other events and practices. Although the human elements can override any system of controls, it is clear that there are a range of actions that are critical to the effective functioning of the system underlying capital markets that require attention. In addition, a strong enforcement function with appropriate civil and criminal sanctions is also needed to ensure effective accountability when key players fail to properly perform their duties and responsibilities.

The accounting profession's self-regulatory system has not effectively fulfilled its responsibilities. In addition, the current model whereby the SEC oversees various self-regulatory organizations in connection with financial reporting and auditing has not worked well, especially in connection with audits of public companies. Further, the SEC is not staffed to take on a more direct role in regulating the accounting profession nor has the SEC strategically managed its limited resources well. Therefore, we strongly believe that a new independent body, created by statute to regulate audits of public companies, is needed in order to better protect the public's interest. However, currently we do not believe that it is necessary or appropriate for the government to assume direct responsibility for financial reporting. We do, however, believe that the Congress should provide the SEC with direction to address the issues concerning financial reporting as we have previously discussed.

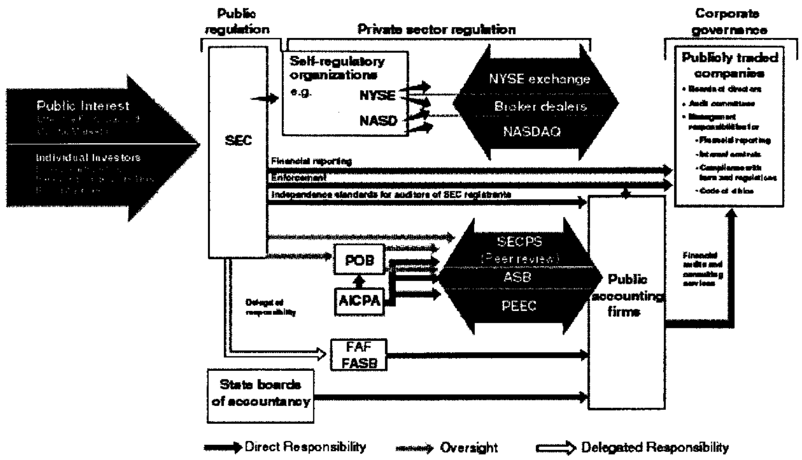
In summary, Enron's recent sudden collapse, coupled with other recent business failures and certain other activities, pose a range of serious issues concerning the accounting profession and financial reporting that should be addressed. The fundamental principles of having the right incentives, adequate transparency, and full accountability provide a good sounding board to evaluate proposals that are advanced. In the end, no matter what improvements are made to strengthen the oversight and independence of the accounting profession and enhance the relevancy and transparency of financial reporting, bad actors will do bad things with bad results. We must, however, strive to take steps to minimize the number of such situations and to hold any violators of the system fully accountable for their actions.

We would be pleased to meet with you or other members of the committee to answer any questions that you may have or to provide further assistance.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Enclosure



Public regulation
Private sector regulation
Corporate governance
Public Interest
Individual Investors
SEC
Self-regulatory organizations
e.g.
NYSE
NASD
NYSE exchange
Broker dealers
NASDAQ
Publicly traded companies
Financial reporting
Enforcement
Independence standards for auditors of SEC registrants
POB
AICPA
SECPS
(Peer review)
ASB
PEEC
Public accounting firms
Delegated responsibility
FAF
FASB
State boards of accountancy
Direct Responsibility
Oversight
Delegated Responsibility

July 1, 2002

The Honorable
Paul S. Sarbanes
Chairman, Committee on Banking,
Housing and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

We write in support of the proposed "Public Company Accounting Reform and Investor Protection Act of 2002" (the "Accounting Reform Act"). Although there are provisions that one or more of us might quarrel with, the Accounting Reform Act is the best approach to reform among the various legislative and agency proposals now in circulation -- by far.

The case for reform was persuasively established in your Committee's hearings. The Securities and Exchange Commission, in its recent Release No. 33-8109, concluded that "the oversight mechanism for insuring that public companies have their financial statements audited by skilled, disinterested professionals operating under high ethical standards and strict quality control procedures is not working as intended."

We applaud the stated purposes underlying the SEC's proposals, which are essentially the same as those supporting the Accounting Reform Act. It is our opinion, however, that without specific Congressional authority of the sort intended by that Act, the SEC's efforts at rule making to establish an oversight board are uncertain to achieve the effective reforms needed. The problem arises from serious doubts as to the SEC's powers to achieve the

goals of its recent release. Our specific concerns are summarized below.

1. <u>The Need for Legislation</u>. Effective powers to investigate and discipline are essential. It is uncertain whether the SEC has the power to assure the oversight board of the following protections, each of which is an important element in assuring its effectiveness:

a) Privilege from discovery of investigative files.
b) Immunity from private civil liability.
c) Protection from antitrust violation for group boycott or other activity violative of antitrust principles.

Each of these protections have been available to NASD Regulation, Inc. because it was created under specific legislation to receive from the SEC, and to perform, delegated law enforcement powers subject to supervision by that governmental agency. Absent specific legislation creating the oversight board, it is uncertain whether the SEC has statutory authority to bestow those protections. Even if the SEC were ultimately successful in its assertion of power, effective reform will wait on the sidelines while, unavoidably, the SEC experiences years of litigation that will needlessly consume staff time and its limited financial resources.

More generally, serious questions have been raised as to the SEC's authority to even create the oversight board it proposes. Historically, on the other principal occasions when a new regulatory body under the mantle of the SEC has been created, Congress has acted. Thus, NASD Regulation, Inc. is not a precedent in support of the SEC's asserted powers because it is a creature of statute. We would expect the disciplinary and fee-imposing powers that the SEC proposes to delegate to the oversight board to become the subject of extended litigation, with

the outcome uncertain. To build this important oversight and accountability structure on so weak a foundation is unwise.

2. Enforcement Powers. As a private body, the proposed oversight board can only discipline or fine accounting firms and persons who wish to remain employed by them. Thus, if a partner or employee is fined by the board, that person has only to resign from the accounting firm in order to escape the obligation to pay. In contrast, a legislatively created board could be authorized to impose fines and other sanctions that could not be escaped in so simple a fashion.

3. Independence. We question the effectiveness of the SEC's design to achieve a central tenet of its goal: to make the accounting profession "subject to a private sector system of regulatory oversight directed by representatives of investors and issuers, not self-regulation by the profession."

As proposed in the release, one-third of the oversight board's members could be practicing accountants. Their self-interest would be likely to confront their public responsibilities as board members on a regular basis. Even the initial so-called "public members" of the oversight board, who would comprise 2/3rds of the membership, would be selected by the accounting profession when it constitutes the oversight board for acceptance by the SEC. Watchdogs who are selected by those whom they are intended to watch constitute, at best, dubious guardians, not ones who will restore investor confidence in the audit profession.

We think the approach to selection of members of the oversight board contained in the Accounting Reform Act, involving the SEC in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, is much more likely to assure the oversight board's independence.

Very truly yours,

John C. Coffee, Jr.
Adolf A. Berle Professor of Law,
Columbia University Law School

Bevis Longstreth
Former Commissioner, Securities and
Exchange Commission and Member of
Panel on Audit Effectiveness

Joel Seligman
Dean and Ethan A. H. Shepley
University Professor, Washington
University School of Law

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 3, 2002

The Honorable Phil Gramm
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Gramm:

I am writing, at your request, regarding the July 1st letter provided to Chairman Sarbanes by John C. Coffee, Bevis Longstreth and Joel Seligman in support of the proposed "Public Company Accounting Reform and Investor Protection Act of 2002" (the "Act").

I am glad to have the opportunity to correct apparent misunderstandings in the July 1st letter regarding the Commission's recently proposed rulemaking to create a framework for a Public Accountability Board.

First, the letter points to various "uncertainties" and "doubts" regarding the Commission's authority to achieve its goals and raises the possibility of litigation if the rules are adopted. The letter pointedly does *not*, however, contain a statement that, in the authors' opinion, the Commission lacks the authority to adopt the rules it has proposed.

The existence of "uncertainty" and the risk of litigation are, as you well know, inherent in our legal system — in the legislative as well as the rule-making context. It is plainly a misapprehension of our regulatory processes to suggest that this unremarkable fact should be cause for adopting legislation. Moreover, it is notable that in recent press reports, Professor Seligman is quoted as saying, in the context of identifying the possibility of litigation, "*I believe an appropriate construction of the Exchange Act is that the power is there.*" (THE NEW YORK TIMES, June 21, 2002, page 1, column 2).

In fact, as discussed at our June 20th open meeting, based on a careful review and consultation with its Senior Staff, the Commission unanimously concluded that it had the authority to proceed with its proposed rule.

Second, the letter mistakenly suggests that the Commission's proposed rules could be subverted through an individual's resignation from an accounting firm. This reflects a misreading of the proposed rules, which differ from the Act in that they would require membership by individual accountants, not just accounting firms. Thus, the resignation of an individual would not have the effect the authors describe.

Third, the letter contains the incorrect statement that, under the Commission's proposal, the public members of the oversight board — constituting two-thirds of its membership — "would be selected by the accounting profession." In fact, the rules specifically prohibit the inclusion among the board's public members of individuals with any significant ties to the accounting profession — and the Commission would have the express authority to reject any oversight board that attempted to circumvent this requirement.

Let me underscore that our goal has been, and will continue to be, to work with Congress to produce the best result for investors and the nation's securities markets — regardless of whether that occurs through the legislative or regulatory process. I do not believe that correspondence of the type submitted on July 1, 2002 is constructive in moving us toward that goal. I look forward to continuing to work with you and other members of Congress to achieve our shared objectives.

Your truly,

Harvey L. Pitt

Harvey L. Pitt

cc: Chairman Paul S. Sarbanes

STATE OF NEW YORK
OFFICE OF THE ATTORNEY GENERAL
120 BROADWAY
NEW YORK, NY 10271

ELIOT SPITZER
Attorney General

(212) 416-8050

June 5, 2002

Honorable Paul Sarbanes
Chairman
Committee Banking, Housing, and Urban Affairs
SD-534
Washington, D.C. 20510

Dear Chairman Sarbanes:

As you know, my office has been conducting an on-going investigation of equity research and research analysts at major brokerage/investment banking firms headquartered in New York. Problems in this area have existed for several years and recently appear to have grown worse. I write to share with you and your committee some of our findings to date that may be of assistance to the Committee.

Evidence we obtained during the first phase of our investigation, which focused on Merrill Lynch, shows that research reports and stock ratings of companies that were potential or actual banking clients of Merrill Lynch were often distorted to assist the firm in obtaining and retaining investment banking business. One management document we obtained actually acknowledged the conflict and its results, stating: "We are off base on how we rate stocks and how much we bend backwards to accommodate banking, etc.". We believe that the lack of research independence from investment banking likely extends to other firms as well.

A number of the issues we are investigating were raised by witnesses at your recent hearings on "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies." My staff has carefully reviewed your hearing record and it is my understanding that studies were cited suggesting that analysts associated with underwriters were less objective in their research than independent analysts. You also received testimony showing that securities analysts report that they are frequently pressured to make positive recommendations or at least to temper negative opinions. One of your witnesses stated, "Some of the companies may intimidate analysts into being bullish. Those who stand up may face less access to company information and perhaps backlashes too."

Evidence that we have obtained confirms what you heard, namely that analysts are subjected to significant pressure with respect to their research. Documents produced by Merrill Lynch show that pressure came not only from covered companies, but also from Merrill's own investment banking department. Merrill analysts were actively involved in investment banking sales efforts, participating in roadshows and marketing under writings to important institutional clients. The lead internet analyst at Merrill Lynch estimated that at one point he was spending over 50 percent of his time assisting investment banking.

The method by which many analysts are compensated exacerbates their conflict of interest and lack of independence. Documents and testimony obtained in the course of our investigation indicate that analyst compensation is often tied to an analyst's contribution to the investment banking side of the firm's business. Merrill Lynch analysts, for example, were asked to submit a year-end report detailing contributions they had made to investment banking during the year. One analyst's compensation rose from $3 million per year to $12 million per year, after he submitted the requested summary of his group's contribution to investment banking.

We are proceeding with our investigation and enforcement of New York's anti-fraud statute. However, we believe that the problem posed by analyst conflicts of interest can best be solved through a combination of greater disclosure and significant institutional reform.

Although a start, the proposed regulations by the National Association of Securities Dealers and the New York Stock Exchange fall short of what should be legislated in this area. For example, the regulations fail to address the problem of intimidation or retaliation against analysts who publish unfavorable research about a company. At a minium, these proposed regulations should be codified so there can be no backsliding by the industry or the regulators.

In conclusion, based on my investigations, to date, I believe that the analyst conflict provisions in your bill are an important first step in addressing a number of the abuses we uncovered in our recent investigation. I urge you and members of the Banking Committee to resist efforts to water down or strike these provisions.

In my opinion, investor protection and the public interest demand that these issues be addressed in your legislation.

Sincerely,

ELIOT SPITZER
Attorney General

ACCOUNTING REFORM AND INVESTOR PROTECTION

WEDNESDAY, MARCH 6, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

Because of the nature of the Senate schedule and the time constraints that some Members have, I am going to invite the panel of two people to come on up. We will just do one panel because, otherwise, I am afraid that we are just going to run over.

So if we could just take the other two witnesses and put them on either end, I think Senator Gramm and I will be able to work that within the time constraints. As you well know, you never can control the Senate schedule from 1 day to the next.

Today, the Committee continues its examination of auditing standards, corporate financial reporting, and investor protection. As almost all of our previous witnesses have pointed out, Enron is but one example of underlying weaknesses within our system. In fact, *The Wall Street Journal* noted yesterday, and I quote them:

> It is hard to deny that the boom of the 1990's produced some faster and looser behavior by business. John Goble, the former head of Vanguard, recently pointed out that U.S. companies restated their earnings 607 times in the past 3 years, more than in the entire previous decade. Granted a company's income statement is not everything, but it ought to be more than fiction.

Accounting abuses and lagging standard setting are not new problems. Neither are attempts to solve those problems through private studies.

The debate about purchase versus pooling for business combinations in the 1960's led ultimately to the creation of the Financial Accounting Foundation—Financial Accounting Standards Board structure, after a report written by a group headed by former SEC Commissioner Francis Wheat.

The Commission on Auditors' Responsibilities, headed by former SEC Chairman Manny Cohen, was created in 1977, after the Penn Central failure and the equity funding and foreign bribery scandals of the 1970's. Its job—in words that are actually still appropriate—was to: "Develop recommendations regarding the appropriate responsibilities of independent auditors . . . [and] consider whether

a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish."

The failures at Penn Square Bank, Continental Illinois, Drysdale Government Securities, and Baldwin United, among others, in the 1980's, led to the creation of a National Commission on Fraudulent Financial Practices, led by former SEC Commissioner James Treadway.

An SEC request that the Public Oversight Board "examine whether recent changes in the audit process serve and protect the interests of investors" led to creation in 1998 of the Panel on Audit Effectiveness, Chaired by Shaun O'Malley, former Chairman of Price Waterhouse. The O'Malley Report was issued in August 2000.

Unfortunately, only a fraction of the recommendations made by these reports have been adopted.

So, we have some veterans of this process here with us this morning and we are looking forward to hearing from them.

Mr. O'Malley, I will yield to Senator Gramm for a moment for a statement, and then we will go to you first, since you did the most recent study of audit effectiveness. And then we will branch out across the panel with Mr. Seidler, Mr. Wyatt, Mr. Longstreth, and Professor Briloff.

Senator Gramm.

STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, I will be brief. First, I want to again, as I have on all the other occasions that we have held hearings in this area, commend you. I think of all the Congressional hearings held on issues related to Enron and similar problems, that yours have been the most productive.

Chairman SARBANES. Potentially, the most productive.

[Laughter.]

Senator GRAMM. Well, I think that they have been the most productive in terms of focusing on the real role of Congress, which is forward-looking in terms of what we can do to improve the system. I think it is a compliment that you are due to be paid.

Second, let me thank all of our witnesses today. We are in the midst of, I think, excellent hearings. Accounting is not as simple as I thought it was after I completed my two mandatory courses as a sophomore in college. I knew it was burdensome when I had to do the old practice sets, which made me decide that I did not want to be an accounting major.

We have talked about real issues in accounting and in dealing with our changing financial structure as we have looked at how you account for mergers and acquisitions, as we have had a long and heated debate about how you account for stock options, it is clear that this is a complicated issue.

The principles are simple. The applications are complicated.

On this Committee, we are going to try, once we have gathered all the facts we can and gotten the input we can, try to see what we can do to improve the situation, recognizing that for every change, there are costs and benefits.

One of the principles that I have tried to live by as a lawmaker is, "Do no harm." I think what we have to do is to figure out what we can do that will clearly be beneficial, where the benefits in

terms of economic growth and job creation, the ultimate test of a capital market, exceed the costs. And so, your input in that, given your vast experience and your involvement in these debates over these many years, is much appreciated.

Chairman SARBANES. Thank you very much.

Mr. O'Malley, I should have also mentioned, is the retired Chairman of Price Waterhouse. As I said, he Chaired the Panel on Audit Effectiveness, and was the President of the Financial Accounting Foundation in the early 1990's.

Mr. O'Malley, we are pleased to have you here this morning. We would be happy to hear from you.

STATEMENT OF SHAUN F. O'MALLEY CHAIRMAN, 2000 PUBLIC OVERSIGHT BOARD PANEL ON AUDIT EFFECTIVENESS (O'MALLEY COMMISSION) FORMER CHAIRMAN, PRICE WATERHOUSE PAST PRESIDENT, FINANCIAL ACCOUNTING FOUNDATION

Mr. O'MALLEY. Thank you very much, Mr. Chairman.

I would just like to ask, I notice my game clock here says 5 minutes, and I was told that we would have up to 10 minutes.

Chairman SARBANES. Yes. This thing is set in a way——

Senator GRAMM. We lied.

[Laughter.]

Chairman SARBANES. Five to 10 minutes, if you could.

Mr. O'MALLEY. All right.

Thank you very much. I should say also by way of introduction, I spent 36 years working in the accounting profession, the vast majority of them as an auditor.

Like everyone, I am shocked by the Enron debacle. As I explain in more detail in my written statement, it appears that Enron represents a breakdown in every one of the safety nets that guard our corporate reporting process—corporate management, the board of directors and audit committees, law firms, auditing firms, securities analysts, commercial and investment banks, credit-rating services, the Financial Accounting Standards Board, and the SEC—all seem to have failed in some respect and their combined failure led to the largest bankruptcy in corporate history.

There have been a number of proposals concerning reform of the accounting profession. I would like to assist in your consideration of these proposals by sharing with you the recommendations of the Panel on Audit Effectiveness, which I Chaired from 1998 to 2000.

The Panel was appointed by the POB at the request of the Securities and Exchange Commission, to review, to evaluate, and to recommend improvements in the way independent audits are conducted and to assess the effects of recent trends in auditing on the public interest. The almost 2 years of work by the Panel involved a massive undertaking, a description of which may be found in my written statement.

In the end, the Panel published a report that set forth our findings and our recommendations for hundreds of changes in the way audits are conducted. Of the more than 250 pages of this report, the Panel spent three full chapters discussing a host of recommendations designed to improve audit quality.

Let me emphasize that.

At the end of the day, enhancing audit quality has to be the primary goal of our response to the problems at Enron. It is a matter of concern to me that in the context of proposed reforms that target the accounting profession, so little is being said in the media about whether or how the various proposed solutions will improve audit quality. Yet that is the issue upon which we must ultimately focus our attention if something positive is to come out of these unhappy events.

The recommendation of the Panel made prior to Enron's collapse bears some similarity to proposals discussed by the SEC and in Congressional hearings. I will describe the thrust of the Panel's recommendation in the context of three themes. First, the need for improved audit quality. Second, the call for the separation of audit and nonaudit functions. And third, proposals for change in the governance of the accounting profession.

First, our recommendations for improved audit quality. The Panel made some 150 specific recommendations toward furthering the quality and reliability of audits. Some of the most important of these recommendations were: One, that auditors be required to adopt new forensic-type procedures and an overall new approach to detecting fraud; Two, that the Auditing Standards Board issue clearer, more definitive auditing standards; Three, that auditors be required to attain a much deeper understanding of an issuer's business and internal controls, and that accounting firms take to heart the importance of the investing public of quality audits and that firms emphasize this importance in every way possible, from communications by top management to compensation and advancement decisions.

Let me comment on what I believe to be the boldest of these initiatives, which is that auditors be required to approach their audits with more of an eye toward the detection of fraud by a company's management.

The Panel recommended that auditing standards be enhanced to require auditors in planning and performing certain phases of their exam to presume the possibility of dishonesty at various levels of the company's management, including the possibility of collusion.

The Panel also recommended a number of specific forensic measures to be taken during any audit, with the principal objective of detecting material financial statement fraud. An auditor's ability to investigate fraud will always be limited. The Panel believed, however, that this dramatic shift in approach would not only help auditors to discover material fraud, but would also more likely deter fraud from occurring in the first place.

I was heartened to see that last week, the Auditing Standards Board issued an exposure draft which would, if adopted, replace the current audit standard relating to fraud. I am reviewing the proposal to determine whether it will accomplish what the Panel sought to achieve in its recommendation.

Let me now turn to the topic of auditor independence and the scope of services issue. Because of the fundamental importance of auditor independence to the quality of and confidence in public audits, the Panel dedicated a full chapter of its report to auditor independence and specifically, to accounting firms' provision of nonaudit service to clients. Of the 126 publicly-related audit engage-

ments studied by the Panel, the Panel identified 37 of those engagements in which services other than audit and tax had been provided. The Panel's reviewers did not find any instances in which providing those services to audit clients had a negative effect on audit effectiveness. Indeed, the Panel found that on roughly a quarter of such engagements, nonaudit services actually had a positive impact on the effectiveness of the audit.

Based on an independent survey, we found that many people remain concerned that the performance of nonaudit services for audit clients creates at least the appearance of an impairment to auditor independence. And considering this thorny issue, the Panel did not reach a unanimous recommendation as to whether or not a ban on nonaudit services to clients was advisable, and if so, which services should be in or out. However, since that time, the SEC by rule has banned the provision of many nonaudit services to audit clients. And recently, all five of the major firms have agreed to end the performance of two types of nonaudit services to clients: First, financial information systems design and implementation; and second, internal audit out-sourcing.

These types of engagements generate substantial fees for accounting firms, and as the Panel found, create at least a perceived threat to auditor independence.

The net result of the action by the SEC and the decisions by the firms is that substantial amounts of so-called consulting dollars are off the accounting firms' table.

Going forward, I am not confident that the lines drawn in the political or legislative process with regard to permissible scope of services will most effectively enhance the quality of public audits. I believe some expert entity, like the now-defunct Independent Standards Board, could develop a framework to identify independence threats and provide guidance on appropriate safeguards.

I would strongly urge that whoever is charged with oversight of this issue, utilize the framework and methodology developed by the ISB, a clear guide to appropriate regulation.

I also believe that audit committees should take it upon themselves to review nonaudit engagements with the company's auditor using certain guiding principles such as those recommended in the Panel's report.

Let me now discuss the issue of governance of the accounting profession.

The profession's combination of public oversight and voluntary self-regulation is extensive, Byzantine, and insufficient. The Panel found that the current system of governance lacks sufficient public representation, suffers from divergent views among its members as to the profession's priorities, implements a disciplinary system that is slow and ineffective, lacks efficient communication among its various entities and with the SEC, and lacks unified leadership and oversight.

In light of these significant shortcomings, the Panel recommended the formation of a strong, unifying oversight body to help ensure the effective working of the profession's standard setting, monitoring, disciplinary, and special review functions.

In the Panel's opinion, the experience and expertise of the Public Oversight Board could have served as a sound foundation for such

an organization, a body to whom the SEC, the State boards, the auditing profession, and the public would look for leadership.

Unfortunately, the POB has all but disbanded. There are, however, many similarities between our Panel's proposals and those considered by the SEC and the Congress.

I am in favor of the creation of an organization to oversee the accounting profession, whether it is created by regulation or by legislation. If carefully structured to ensure effective oversight, disciplinary proceedings and rulemaking in an unpoliticized environment, such an organization could serve the same purpose we had in mind for an expanded POB.

There are important considerations in structuring a new entity.

First, it must be decided whether the new organization will assume an oversight role similar to that proposed by the panel, or whether it will assume some or all of the responsibilities of existing bodies. In this regard, if the new body is created by statute, the Congress should provide statutory confidentiality protection for the materials, interviews, and findings developed as part of the new organization's peer review, investigatory, and disciplinary functions.

I believe the Auditing Standards Board remains the appropriate entity for establishing audit standards. But a new organization should oversee its activities and ensure that the ASB continually reexamines and addresses emerging auditing issues on a timely basis. And although today, the FASB is beset with political pressure that directly hampers the accounting standard setting process, in my view, the FASB remains the right entity for determining accounting standards.

A second consideration is that any new oversight organization must remain independent from the profession, but mindful of current issues and trends affecting the profession. There should be an appropriate balance of members from outside the profession, public members, and the profession.

Third, Congress should ensure that the oversight organization is sufficiently staffed and funded to carry out its sizable mandate. If a new organization assumes review responsibilities currently undertaken as part of the peer review system, it will have to do the job that is now done by hundreds of experienced employees, managers, and partners assigned by the firms.

Finally, in view of the various efforts at the State level in the wake of Enron, I believe if a new oversight organization is created, Congress should ensure that national accounting firms are subject to a clear and consistent set of regulations and do not find themselves guided by multiple, conflicting sets of rules.

Our capital markets are not broken. They may have been bent a little, but they are wonderfully resilient and have stood the test of time. I believe that much can and should be done by the accounting profession, and by the other participants in our safety net, to restore confidence in our capital markets and protect the investing public. And, I believe that Congress can play a constructive role in holding the type of hearings that have been undertaken by this Committee and, if necessary, once all the facts are gathered, by crafting legislation in the public interest. I do want to urge caution in whatever legislative proposals are advanced, because I fear that

a hastily-crafted package could potentially harm, rather than help, the cause of audit reform.

I appreciate the opportunity to give you my views, and I will be pleased to assist this Committee in whatever manner would be most helpful.

Mr. Chairman, that concludes my remarks and I am sorry that I went a minute over here on my time.

Chairman SARBANES. We are very pleased to have you, sir.

We will next hear from Lee Seidler, a General Partner and Senior Managing Director of Bear Stearns. Actually, he is now Managing Director Emeritus, as I understand it. And as I mentioned earlier, was the Deputy Chairman of the Commission headed by former SEC Chairman Manny Cohen.

Mr. Seidler was a Professor of Accounting at New York University's Graduate School of Business Administration for 20 years. He is the author of a number of books on accounting and taxation. And he served on the audit committees of a number of companies where he has been a member of the board of directors. And so, we are very much looking forward to his perspectives this morning.

We would be happy to hear from you, Dr. Seidler.

STATEMENT OF LEE J. SEIDLER DEPUTY CHAIRMAN OF THE 1978 AICPA COMMISSION ON AUDITORS' RESPONSIBILITIES MANAGING DIRECTOR EMERITUS, BEAR STEARNS

Mr. SEIDLER. Thank you, Mr. Chairman and Senator Gramm, for inviting me to testify today.

I should mention that from time to time I act as an expert witness for the Enforcement Division of the SEC. My title of Managing Director Emeritus of Bear Stearns calls for no work, no pay, but it does entitle me to free lunch at the partners table on occasion.

[Laughter.]

I will be presenting a summary of my written testimony, and I would request that my written testimony be placed in the record.

Chairman SARBANES. The full written testimony will be included in the record.

Mr. SEIDLER. Mr. Chairman, you read the charge to the Cohen Commission. I would like to read a couple of sentences that follow, which are our conclusions:

> The charge suggests the possibility that a gap exists between the performance of auditors and the expectations of the users of financial statements. The Commission concludes that such a gap does exist. However, the principal responsibility does not appear to lie with the users of financial statements. In general, users appear to have reasonable expectations of the abilities of auditors and the assurances they can give. The burden of narrowing the gap falls primarily on auditors and other parties.

We said that in 1978. And in 1978, we also said:

> The public accounting profession has failed to react and evolve rapidly enough to keep pace with the speed of change in the American business environment.

And unfortunately, a quarter of a century later, I have to repeat that. It is identical.

As you said earlier, most of our recommendations were not taken. I would like to mention a few that I would consider the most critical that were not taken, then move to a suggested action on your part.

First of all, the Commission recommended that we stop auditing financial statements and instead, convert into an audit function. That is that the auditor be essentially the auditor of the auditor of the company and that the audit be essentially a continuous function. From that flowed our recommendation, which was revolutionary in those days, that all published quarterly reports be reviewed by auditors. And that was ultimately taken. However, if we move ahead 25 years, it would seem to flow that now all quarterly reports ought to be audited as part of an integrated audit with the year-end financial statements.

Second, we recommended that auditors evaluate the financial statements as a whole. Commission member Leroy Layton called that the smell test.

Then, and now, auditors have to evaluate the cumulative effect of uncorrected misstatements and decide what that is on the financial statements as a whole, and I will talk a bit more about that. We said, take a positive look. Evaluate the cumulative effect of the selection application of all the accounting principles and decide if the total picture presented by the financial statements is there. No steps have been taken on that at all.

Auditors today, and then, opine that the accounting principles used by the company are acceptable. Then, as now, if a company changes an accounting principle as between one alternative to another acceptable alternative, the auditor and the company must opine that the new accounting principle is preferable.

The Cohen Commission said, we see no reason to opine on preferability only when a change is made. So, we suggested that the auditor always ought to opine that when there are alternative accounting principles, the principles selected by the company are preferable. No action has been taken on that suggestion, either.

And I would add that, certainly, a lot of the disclosures in Enron and some other cases have suggested another form of accounting principles, barely acceptable accounting principles, where transactions have been structured to fit under a line. I think if a preferability requirement were put in, that would eliminate the notion of just squeezing in under the line of acceptability.

Materiality is an accounting concept that most people do not know about. Materiality, however, is the very strongest accounting principle. Every statement issued by the Financial Accounting Standards Board, and by its predecessors, the APB, includes the following statement:

> The provisions of this statement need not be applied to immaterial items. In other words, if the decision is made that an item is not material, it does not have to be accounted for correctly. No matter how egregious, no matter how authoritative the particular standard is, if it is not material, it does not have to be accounted for correctly.

In my written testimony, I describe some of the bizarre accounting used by Waste Management, audited by Arthur Andersen, taking it from the SEC release. And that accounting was ultimately, although totally egregious, would have been spotted by one of my Accounting 101 students, was simply decided to be not material and therefore, was permitted to go through.

The problem, however, is that there is no workable definition of materiality. There is a legal or legalistic definition, but really is not one that accountants can apply on a day-to-day basis.

The Cohen Commission in 1978 noted that in 1975, the FASB had issued a discussion memorandum on materiality. That is the predecessor to going to work on a statement. Unfortunately, since then, not a single piece of paper has emerged from the FASB on materiality. The SEC issued a slight clarification recently, but still, there is no definition.

I propose a simple standard that would resolve many of these problems. I said earlier that uncorrected misstatements in financial statements have to be aggregated and the conclusion has to be that they are not material.

I raise this simple question—why have any uncorrected misstatements in financial statements? If the auditors find an error in the financial statements, why not correct it, no matter what it is, no matter how large it is?

In the old days, if you will, precomputer days, making a correction near the end of the audit meant changing lots of schedules and changing the statements that have been produced. Today, I have a $149 accounting program in my laptop computer. If there is a set of financial statements in there and I put in a journal entry, one correcting entry, in about a hundredth of a second, new financial statements are created and it is all corrected. Therefore, there seems to be absolutely no logic in doing anything other than saying, when an auditor finds an error, correct it. Forget about the materiality.

I will also tell you that, in my experience in testifying for the SEC, materiality was the major issue, and usually the major issue on uncorrected misstatements found by the auditors. This would eliminate that major problem.

I won't dwell on the last one extensively, and that is to eliminate nontraditional management consulting because there seems to be a great deal of agreement that consulting outside the traditional realm of accounting should be eliminated.

I will say that my conclusion is not based on empirical evidence, but as it was said by my companion here, it is the fees that are the real problem, the huge fees from consulting which make it much more difficult for an auditor to be the one who lost the Enron account or the Waste Management account. And I would like to take as much fee temptation away.

I will offer a note of caution, however.

Smaller businesses, nonpublic businesses, benefit greatly from the advice of their auditors. And in carving out any restriction on consulting, I would hope that you would take caution with the smaller businesses.

I would point out that and I am, for example, on the board of a small public company, too small to afford an investment banker, and we have received some time ago a buy-out offer. Our audit partner came to the board and actually gave the best advice about how to deal with this particular buy-out.

I would suggest that any advice, consulting, that can be given by the audit staff, by the audit partner, should not be precluded.

My conclusion is that the profession hasn't acted in 25 years, as you say. The question is, where do we go? I suggest my solution reluctantly.

I am a CPA. My father was a CPA. I taught for 23 years. In a largely unregulated profession, I believe now we need to create a regulatory body and I would suggest a body in the image of the NASD, which has done an excellent job of regulating the securities industry. And I would propose that in that body, we do not have to create a new group from scratch. I propose taking the standard setting portions of the AICPA—that is, the Auditing Standards Board, the Accounting Standards Executive Committee, along with the SEC practice section—and move those into the new statutory self-regulatory organization.

I would also suggest taking the Financial Accounting Standards Board and moving that into the same organization. I think by doing that, we would create a body which has both the standard setting and the regulatory ability, and would be able to act much better to create change.

I would also say be careful not to interfere with the State societies when you do this because some of the State societies, particularly New York State Society of Certified Public Accountants, are far more creative than the American Institute of CPA's. I would like to allow them to continue in their way.

In finishing, I would like to make a plea or just a recommendation that is not within your legislative purview, and that concerns accounting education.

Twenty-five years ago, the Cohen Commission pointed out that there is no graduate professional education in accounting. Accountants have to go to undergraduate school, basically. There is no graduate professional schools, no graduate professional degrees offered. And we said that was robbing the accounting profession of some of the best manpower, those people who go through undergraduate and opt for graduate school later on.

Twenty-five years later, with the number of students following that career perhaps tripling, the accounting profession, unlike law, medicine, architecture, compute science, business, physical and social sciences, and even pharmacy, does not offer a graduate degree.

The accounting profession is essentially starving for manpower. It reminds me of the story of the farmer who, in order to save money, decided to cut down on feeding his cow a little bit every day. It was going very successfully, he finally got the feed down to zero, and the cow fouled the whole thing up by dying.

[Laughter.]

The accounting profession is doing about the same thing in its manpower. And I urge you—you cannot legislate it, but perhaps you can recommend to the State boards of accountancy, that they try to increase the accounting education requirements.

In conclusion, I would just like to read a very brief statement which came from Senator Francis T. Maloney, who sponsored the 1938 Maloney Act Amendment of the Securities Exchange Act of 1934, which created the NASD. He said: "This Act is designed to effectuate a system of regulation in which the members of the industry will themselves exercise as large a measure of authority as

their natural genius permit." I hope you can do the same thing for the accounting profession.

Thank you.

Chairman SARBANES. Thank you very much. It is very helpful testimony.

We will now hear from Arthur Wyatt, retired Managing Director of Arthur Andersen, Professor Emeritus of Accountancy at the University of Illinois, his alma mater. Mr. Wyatt has served as President of the American Accounting Association, has been a member of the Financial Accounting Standards Board, Chairman of the International Accounting Standards Committee.

I ought to mention that both Mr. O'Malley and Professor Wyatt are members of the Accounting Hall of Fame, which is located at Ohio State University.

Actually, that group includes Arthur Andersen himself, who had a very distinguished career, as I have noted here on a couple of occasions. And Charles Bowsher, former Comptroller General of the United States, who will be before the Committee, not next week, but the week after next.

Mr. Wyatt, we would be happy to hear from you, sir.

STATEMENT OF ARTHUR R. WYATT, CPA FORMER CHAIRMAN, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS' ACCOUNTING STANDARDS EXECUTIVE COMMITTEE FORMER CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE FORMER PARTNER, ARTHUR ANDERSEN & CO. PROFESSOR OF ACCOUNTANCY EMERITUS UNIVERSITY OF ILLINOIS

Mr. WYATT. Thank you, Mr. Chairman, Senator Gramm, Senator Miller. I am pleased to be before you today. I have some brief prepared remarks——

Senator GRAMM. Arthur, would you pull that microphone up a little bit?

Mr. WYATT. Yes. And I would respectfully request that the full text of my written testimony previously submitted to you be entered into the public record.

Chairman SARBANES. Without objection, it will be included in the record in full.

Mr. WYATT. Before dealing with the specific issues raised in your invitation to appear here today, however, it may be helpful to provide some background on the evolution of the large public accounting firms over the last 35 years. My observation is that over this period, the attitude of the leadership of the large accounting firms has gradually shifted from an emphasis on the quality of accounting and auditing services provided to clients, to emphasis on growing top-line revenues. The impact of this attitudinal change within the firms has been significant, in my view.

No longer is technical expertise and leadership the obvious avenue to progress within the firms. Rather, expansion of clients served and expansion of client services are viewed as the primary drivers. And obviously, the loss of a client is a negative in one's career path.

Since many decisions required of audit firm managers and partners are judgmental in nature, rather than clearly prescribed by external forces, such judgments are, at the margin, sometimes influenced by perceptions of the attitudes of leaders of a given firm.

If those perceptions by audit firm personnel are that the loss of a client is damaging to one's career path, the judgments made may be more in the direction of keeping the client than to achieving fair presentation in financial statements.

I believe the leadership in the various firms needs to evaluate how well their existing organizational structures and reward policies are serving what has to be their primary focus—the delivery of high-quality, professional accounting and auditing services to their audit clients.

While these observations may not be very helpful in considering legislative initiatives, I believe they are crucial for the major accounting firms to address if the firms wish to survive in the private sector as respected reporters on the financial situation and results of operations of business enterprises.

The evolution of the drift toward increased emphasis on commercialization and reduced emphasis on professionalism led the large accounting firms to expand the range of services provided to their audit clients.

Many of these services are logically best provided by the audit firms—tax return preparation and tax planning, evaluation of the accounting alternatives for planned transactions, assistance with financial statement preparation for regulatory purposes, audits or reviews of prospective acquirees in business combinations, are some examples. Indeed, any additional services that are directly related to assuring the fairness of presentation of client financial statements are proper activities for audit firms to undertake.

On the other hand, as the range of services provided broadened, some were clearly creating potential for conflicts with the basic audit services. For example, rendering internal audit services for audit clients was never a sound idea. Likewise, services related to the design of financial reporting systems places the auditor in an awkward position if the system does not function as anticipated.

Actuarial services, executive searches, advice on specific investment decisions, and many more services of this nature that evolved over the years to generate increased revenues, but either have little relationship to the annual audit or may create conflicts of interest, should no longer be permitted by audit firms for their audit clients.

Drawing lines in this area will not be an easy task. Given the current environment, it is certainly possible that some regulations or legislation will suggest scope-of-service restrictions that will damage the auditor's ability to develop the best possible basis for expressing an opinion on the fairness of presentation of the client's financial statements.

The initiatives in this area need to be undertaken, but they must be undertaken with care so that they do not frustrate the auditor's ability to complete top-quality audit services.

Now some comments on accounting standard setting.

Too often, the Financial Accounting Standards Board, FASB, has departed in its final standards from the concepts that it has represented will guide its decisions, generally because interested par-

ties have not only raised objections to conclusions tentatively expressed, but also have effectively lobbied against adoption of those decisions the Board has signaled.

If the accounting standard setting process is to achieve its objectives of providing guidance on appropriate accounting for transactions and events of an entity, the process must be recognized by all participants as being primarily an intellectual process and not primarily a political process.

The Board often receives negative comments from industry constituents, from auditing firm representatives, from Members of Congress, as well as others. When these comments become part of an organized campaign to undermine the direction a standard is taking and recommend alternative conclusions that are not conceptually sound, the mission of the Board is frustrated. Now this is particularly true when the interveners are Senators and Representatives, who, as part of their commentaries, threaten some type of legislation to frustrate the direction that the Board is moving.

While Senators and Representatives have a legitimate interest in the workings of the Board, they need to recognize that their interventions may well lead to Board decisions that are not in the best interests of investors and the broad business community.

Standards that are conceptually sound need not run hundreds of pages to thwart those who would attempt to subvert the intent of the standards. Each standard issued by the Board should contain in the clearest English possible the objective or intent the Board intends to achieve by issuing the standard.

Each standard issued by the Board should contain a clear statement that any one who is applying the standard should review carefully its application to satisfy himself or herself that the objective specified by the Board has in fact been best achieved through the application that has been adopted.

With regard to audit committees, at least the audit committee chairman, and preferably all audit committee members, should have experience in evaluating the business risks and should be sufficiently conversant with accounting issues to raise appropriate questions with an ability to evaluate responses received.

Audit committees should be especially curious about the so-called audit adjustments proposed by auditors, but not made by company accounting personnel.

Audit committees should pressure company accountants and the auditors to resolve any open adjusting entries, either by the company accepting the entry for recording or the auditor concluding that the proposed entry should never have been on the schedule in the first place.

The audit committee concept is a sound one. Through efforts of the New York Stock Exchange and the SEC, improvements in committee composition and mission should continue to evolve. Honest managements and responsible auditing firms should welcome audit committee involvement when such committees are constituted properly, with knowledgeable individuals willing to gain an understanding of the underlying business risk issues and raise questions on appropriate accounting and disclosure matters.

My experience with disciplinary mechanisms, as well as my knowledge base in this area, is sparse. The current mechanism

under the auspices of the American Institute of Certified Public Accountants, however, is clearly not working.

Over the years, the Securities and Exchange Commission has been a generally effective agency working toward improvements in financial reporting. Even so, its resources have probably been far too limited to achieve the optimum level of success in its diverse objectives.

I would be inclined to provide increased funding to the SEC, to have it become and assume the principal role in overseeing the effectiveness of the financial reporting process. Creation of a new agency to undertake this responsibility seems unnecessary in view of the record established by the SEC over the past 65 years.

Thank you, Mr. Chairman. I very much appreciate this opportunity and would be pleased to respond to questions.

Chairman SARBANES. Thank you, sir. Very helpful testimony.

We will now hear from Professor Briloff who is the Emanuel Saxe Distinguished Professor Emeritus at Baruch College of the City University of New York. He holds a doctorate from NYU Graduate School of Business Administration, and is a Certified Public Accountant in the State of New York. Professor Briloff has practiced public accountancy since 1944, almost 60 years. He is the author of a number of books and hundreds of articles bearing on many of the topics that are before the Committee.

Professor Briloff, we are pleased to have you with us this morning. We would be happy to hear from you now.

STATEMENT OF ABRAHAM J. BRILOFF
EMANUEL SAXE DISTINGUISHED PROFESSOR EMERITUS
BERNARD M. BARUCH COLLEGE, CUNY

Mr. BRILOFF. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you today.

About the only light moment for the next 10 minutes might be derived from the quotation that you read from *The Wall Street Journal,* which reminded me of the old quip going way back, that financial statements are very much like bikini bathing suits—what they reveal is interesting, what they conceal is vital.

[Laughter.]

I would like for my prepared statement——

Chairman SARBANES. Professor Briloff, you are going to have to try to keep that microphone close to you. Otherwise, the system doesn't work so well.

Mr. BRILOFF. I would like for my prepared statement to be included in the record: "Accountancy and Society: The Covenant and the Desecration."

Chairman SARBANES. The full statement will be included in the record, without objection.

Mr. BRILOFF. Mr. Chairman and Members of the Committee on Banking, everyone who is privileged to enter into a profession is presumed to have entered into a covenant, a covenant with the forbears of his or her profession who have created a status and stature of that calling. And by definition, since a profession demands service to society, there is also the covenant with society.

The profession of accountancy has a very special covenant because, in the infancy of the securities laws, about 1934 or 1935, by

a 3 to 2 vote, mind you, the accounting profession, and the private-sector of the accounting profession, was given the responsibility, the franchise of auditing the financial statements of publicly-owned companies, the registrants with the SEC.

That is a most valuable franchise bestowed on my profession by the action of the Securities and Exchange Commission some 65 years or so ago. It is that covenant which I say is being violated.

Now the responsibility of the auditing profession, of the accounting profession to society, Mr. Chairman and Members of the Banking Committee, goes beyond just the financial statements, beyond the debits and credits, beyond the balance sheets and the income statements and the statements of cash flows.

It goes to reviewing the entire process of corporate governance and accountability, the totality of governance and accountability, because some agency has to be there to make certain that the corporate engine, the catalyst for the American capitalistic system, American capitalism, is functioning optimally. That is the role and the responsibility of the accounting/auditing profession, which we should be charged to fulfill.

If we reflect for just a brief moment on the effectiveness of the corporate operations impacts on the individuals more directly, more intimately, more regularly, more continuously, than does Government. That which we eat and drink, where we live, how we live, how we carry on our activities, our mobility, all are dictated and directed by corporate activities and corporate decisionmaking.

Certainly, our economic present and our economic future are critically impacted by the way in which our corporate enterprise and our American capitalistic system is functioning, again, with corporations as the catalyst. So it is beyond the mere financial statements toward which I look at in terms of the canvas of the auditor's role and responsibility.

Now to assure the effectiveness of that corporate enterprise, where, mind you, as things have worked out, we have that power-without-property syndrome, as Adolf Berle described it, whereby enormous resources have been delegated by the owners of those resources to managements which, in turn, or who, in turn, exercise the power.

It is to assure the effective exercise of that power that we have created the system of corporate governance and accountability which, if it were to function optimally, would assure the fulfillment of that American corporate enterprise. That system with management at its center then moves outwards to the board of directors, to the management committee, to the independent audit committee, to the independent auditors, to the Securities and Exchange Commission, to the Congress, to the courts, including at various points the professions of the journalists and the lawyers.

All are embraced by what might be termed the system of corporate governance and accountability. It is when that system breaks down and where the auditors fail to fulfill their responsibility that we run into the Enron syndrome.

Now some benchmarks to history which were provided by Mr. O'Malley, Professor Seidler, Professor Wyatt and by repeating them, it is saddening. We have had all of these things occurring heretofore. They are all so self-evident. Why hasn't the situation

been improved in order to accomplish what everyone recognized over the years as being essential?

In 1976, there was the staff study prepared for the Committee under Senator Lee Metcalf called the Accounting Establishment, which described the apparatus which prevailed. And we then had hearings under Senator Metcalf in 1977, from which there then evolved the AICPA's Division for Firms, where they were going to be doing all of this self-discipline and self-regulation, especially with the Public Oversight Board to be overseeing all of this.

Why should it not have been accomplished?

Following that, fortunately, we do have the independent audit committee proposals, which are very, very vital. We then have the S&L crisis in the 1980's. We have the Foreign Corrupt Practices Act in 1977. We have Title III of the Private Securities Litigation Reform Act of 1995. All of those were supposed to correct the problems which we then recognized. And here we are in 2002, seeing the problems, even more critical, even more serious than had prevailed heretofore.

Where do we go from here? That is the reason I know that you invited me to appear before you today.

First, I mean this reasonably seriously, we do not need any new promulgations from the Financial Accounting Standards Board. I maintain that we have a surfeit of accounting rules because the Board does not promulgate standards. They promulgate rules. And the moment they promulgate rules, the firms go back to their Ouiji boards or their computers and they develop programs—how can we circumvent those rules if we want to circumvent those rules, as we saw in the cases of leases, as we saw in the cases of business combinations.

Thirty-two years ago, Mr. Chairman, Members of the Committee, I testified before Senator Hart on the very matter of business combinations. I spoke against pooling.

Some months ago, the FASB aborted pooling, requiring purchase accounting. And I say to you in all seriousness, Mr. Chairman, Members of the Committee, and others who are here, the rules that they now have for purchase accounting makes the situation even more grievous than that which prevailed before the FASB promulgations aborting pooling because of the presumptions that are implicit in purchase accounting in the nonamortization of goodwill. But I want to pass from that. Where do we go from here?

Very quickly, Mr. O'Malley referred to the introduction of the forensic accounting procedures. I say, amen. We know what to do when we are involved in the pathological process of a post-mortem after a fraud has been discovered.

Arthur Andersen did an extraordinarily beautiful job when they did the post-mortem in the Cendant situation, identifying all that Ernst & Young should have done. They did an extraordinary job. And after I completed my analysis of that and congratulating Arthur Andersen, lo and behold, Sunbeam surfaced where Arthur Andersen, as the auditor of Sunbeam, replicated some of the matters that were found with respect to Ernst & Young.

So, we know what to do. Let's do it.

Second, consistent with what Mr. O'Malley indicated, an agency under the SEC maintain a registry of firms who have committed

themselves to the audit of registrants with the SEC, who, by demonstrating their quality, and the system of checks and balances within the firms, have demonstrated that they are qualified to be there. And such an agency would be in the position of disciplining and possibly delicensing or removing them from the registry.

Third, this involves a sea change. I do not want to deceive you.

As a part of the proxy material where the shareholders vote to approve the designation of auditors, the shareholders should direct that the auditors, on their own initiative, prepare the financial statements which would best replicate or reflect economic reality as the auditors see it, without hindrance.

Now the sea change comes about in this fashion. If you look at the auditor's opinion, they do not say, we prepared the financial statements. They do not say, these are our financial statements. No, they say these are management's financial statements, which, somehow or other, have gone above the threshold of GAAP.

Now maybe that is not as high a threshold as we would like. It may not be as close to economic reality as it could be. But, yet, it passes. On their initiative, clearly and overtly, that it is there, the auditor's statements.

Then I come to the sine qua non, which I know is most difficult to accomplish, but yet, so very important. For those firms who have qualified to be the auditors of publicly-held enterprises and applied for that listing, I propose that the statements be developed by the independent auditors on their initiative, clearly and overtly that its their, the auditors statements—absolute—repeat, absolute, underscored—divestiture of all nonaudit services.

I want the auditors of publicly-owned enterprises to be something of a priesthood, as I have indicated in different contexts, one where they recognize, as I indicated in the opening remarks, the importance of their role. By doing so and emphasizing the transcendent import of the audit, the firm's personnel would realize how important that audit is. The whole chain of command would be oriented toward the independent audit, and it would have a salutary effect because the downsizing would permit the tone at the top, which we would presume to be the kind that Professor Wyatt had in mind and that Mr. Treadway had in mind when he spoke of the tone at the top, when he spoke of where the profession should be, would be filtered down.

So instead of rainmaking being the sine qua non within the firm, it would be the quality of the audit.

Then, I concluded my prepared statement by saying, what if we continue to fail by saying, okay, another committee to be designated by the AICPA. Yet another commission like the Cohen Commission. Another period of study.

I say, nonsense.

If we fail, then I respectfully suggest that the SEC pronounce, we do not require certification of the financial statements by independent auditors. Rely on the financial statements from management, reviewed by the independent audit committee, with whatever counselors they might want to select. But then add at the end, caveat emptor, because to me the worst deception is to continue to pretend that the public is getting a safe product when we know,

as we have heard from all the testimony going over 25, 30 years, that there is a quagmire under us.

Thank you. I do not know how many minutes I have exceeded, and if I have, I am sorry.

Chairman SARBANES. Thank you very much, Professor Briloff.

We will turn to our concluding panelist, Bevis Longstreth. I am pleased to welcome him back before the Committee. Mr. Longstreth is a retired Partner at Debevoise & Plimpton in New York. He was an SEC Commissioner in the early 1980's, a Member of the Board of Governors of the American Stock Exchange, and he has written frequently on corporate governance, banking, and securities law.

Bevis, we are very pleased to have you here. We would be happy to hear from you.

STATEMENT OF BEVIS LONGSTRETH MEMBER OF THE O'MALLEY COMMISSION FORMER COMMISSIONER OF THE SECURITIES & EXCHANGE COMMISSION, 1981–1984 RETIRED PARTNER, DEBEVOISE & PLIMPTON

Mr. LONGSTRETH. Thank you, Senator. It is a pleasure to be here.

I agree with so much that has been said. But I will try to say a few things and perhaps put specific points on a few of the observations that have already been made.

I want to say that I am not an altruist in my interest in this subject. I serve on the board of two very large money management firms. We have a great stake in the trustworthiness of financial statements.

I am going to talk about reforming the audit profession, which is our theme. My thesis on that is simple. I think the profession needs reforms in two major respects. First, an effective rule that prevents the delivery of most nonaudit services to audit clients. And second, an effective system of self-regulation.

Despite the SEC's tortured process which gave birth to a new rule, 2–01, just a year ago, the threat to an auditor's independence from performing nonaudit services allowed by that rule remains palpable. And despite the enlarged charter that the Public Oversight Board was given after extensive negotiations led by the SEC, the POB being until recently the most promising vehicle for some kind of at least partially effective self-regulation, the truth is an effective system does not exist and cannot be achieved without legislative reform.

So let me start—what is wrong with the new SEC rule beyond its hideous complexities?

In many respects, it can be criticized, but I just want to talk about one. The SEC adduced strong evidence that providing to one's audit client nonaudit services of any kind or kinds, if large enough in terms of fees paid, may impair independence.

Despite this powerful predicate that the SEC established for rulemaking, the rule adopted fails absolutely in addressing this concern. It is a giant omission and it touches upon one of the two fictions that I want to address today.

Fiction number one is the profession's claim, and it has been a consistent claim for decades, that payments by an audit client to

its auditor for consulting and other nonaudit services, no matter how large, will never impair independence.

Appearances, that is a problem, but in fact, don't worry about it.

Now it defies common sense to claim that large payments for nonaudit services, which management could easily purchase or threaten to purchase from service vendors other than the auditor, do not function as a powerful inducement to gain the auditor's cooperation on how the numbers are presented.

I was delighted to hear Mr. Seidler make the same point.

Audit account partners are expected by their firms to establish close relationships with the managements they serve. They are expected to cross-market to management as full a range of nonaudit services as possible, and that is a natural thing to do if they are allowed to do it. They are compensated by their firm on the basis, among others, of how much revenue they produce from their audit clients. Their stake in maximizing revenue from these clients through cross-marketing is as natural and compelling as any financial reward could be.

To claim that these incentives have no adverse impact on both the fact and the appearance of independence is a fiction, pure and simple.

One basic problem with nonaudit fees which exists regardless of their magnitude, but grows more serious as the fees grow larger, is a basic conflict of interest. The conflict derives from the fact that in performing both audit and nonaudit services, the audit firm is serving essentially two different sets of clients—management, in the case of nonaudit services, which typically are commissioned by and performed for management, and the audit committee, in the case of audit services, which now are by rule commissioned by the audit committee and performed for that committee, the shareholders and all those who rely on the audited financials in deciding whether to invest.

So the audit committee is a fiduciary in respect to each of these two very distinct client groups, duty-bound to serve each with undivided loyalty. It is obvious, and a matter of common experience, that in serving these different clients, the firm will be regularly subjected to conflicts of interest. And these conflicts will tear at the heart of independence.

What is independence? It is the absolute freedom to exercise undivided loyalty to the audit committee and the investing public. That is what we are trying to protect; to assure the auditor has the absolute freedom to be independent.

When other loyalties tug for recognition, and especially when they come from those in a position to enlarge or shrink one's book of business, on which depends one's partnership share, and the share of one's staff, the freedom necessary to meet one's professional responsibilities as an auditor is challenged.

So there is a big hole in the rule.

To plug the hole, I suggest a simple exclusionary rule covering most nonaudit services. And I am not suggesting Congress should get into the business of writing that rule. But I am suggesting the rule needs to be written by an SRO or by the SEC, and the SRO is the other subject that I will come to shortly.

An exclusionary rule would define the category of services to be barred as including everything other than the work involved in performing an audit and other work that is integral to the function of an audit.

In general, the touchstone for deciding whether a service other than the straightforward audit itself should be excluded is whether the service is rendered principally to the client's audit committee acting on behalf of investors to facilitate or improve the quality of the audit and the financial reporting process, or is rendered principally to provide assistance to management in the performance of its duties.

The exclusionary rule could include a carefully circumscribed exception to permit certain types of nonaudit services to be rendered by the audit firm to its client, where special circumstances are found by the audit committee to justify so doing. The rule would be refined and enforced by a legislatively empowered SRO, which is the subject of my second recommendation for reform.

Beyond the two-client problem I have described, and the conflict, there are many additional arguments for exclusion and they are summarized in my written testimony, which I hope can be included in the record.

Chairman SARBANES. Without objection, the full statement will be included in the record.

Mr. LONGSTRETH. I want to mention just one argument here because it seems so compelling to me.

Independence is given important meaning in many situations analogous to auditing, where potential conflicts, while not always certain to impair independence, nonetheless are prohibited in the interest of avoiding the problem. And here's the example.

Consider the independence necessary for a director to serve on an audit committee of a public corporation. For a director to be independent for that purpose, as now generally defined by bodies that have looked at this, a blue ribbon committee, actually, that looked at it—Shaun's committee was not blue ribbon, but I think it was a great committee. I served on it.

Chairman SARBANES. Well, you have bestowed a blue ribbon it. [Laughter.]

Mr. LONGSTRETH. But the blue ribbon committee said, for a director to be independent enough to serve on the audit committee, he must not accept any compensation from the corporation for any service other than the service of being a director. Now, he may be extremely valuable in serving that corporation in some other way. And management may really feel frustrated that they cannot hire him for that purpose. But they cannot because it would impair his independence.

The common-sense parallel to the auditor is both exact and, in my view, compelling. Compensation for services other than the audit function can threaten independence.

Now the second fiction I want to address, fiction number two, is the profession's three-fold claim that: First, the profession has the ability and motivation to regulate itself voluntarily; second, it has done so effectively over the past several decades; and third, there is no need for a legislatively empowered regulatory body led by persons independent of the profession. And if you haven't heard this

argument enough yet, you are going to hear it in spades as the possibility of legislation on this subject increases.

The present system of voluntary self-regulation is completely unsatisfactory. If one looks closely at that system, what one sees is a bewildering maze of overlapping committees, panels and boards piled one on top of the other. They are characterized by complexity and ineffectiveness in matters of central importance to any effective system of regulation.

And since I am out of time, I am going to jump over——

Chairman SARBANES. Take a couple of minutes to finish up.

Mr. LONGSTRETH. Okay. There are very specific reasons why only a legislatively empowered SRO can have a chance at effectiveness.

The NASD is such an animal and it has not had an unblemished record of effectiveness. It had a chance and it has gotten better, and it is doing now, I think, a very important job, which the SEC simply does not have the resources to do itself. So, we need to replicate some thing like that. But the specific reasons, which are rooted in issues of antitrust law, self-incrimination and so on, are laid out in my testimony.

I won't go through that now because it is somewhat technical. But it is critically important to realize that voluntary action will never do the job. And the big element that is missing from volunteerism are these protections against abusing the right against self-incrimination, the protections against violating the antitrust laws, the ability to throw people out of the profession if they do not cooperate, give evidence, turn over documents, testify before the SRO, and so forth.

So it is an easy conclusion to reach when you understand the details. It has to be legislatively empowered.

Now, I just want to make one more point. We have had a lot of history. I am going to go back even further than the others, if I may, because I think there is an important historical analogue that gives meaning to the opportunity you have now on the back of Enron, as momentum builds, to actually do an important legislative job.

Senator Gramm has returned, I want to say something because I was impressed with your statement at the outset of this hearing. You said your first rule was to do no harm, and I applaud that.

I am not a fan of lots of legislation, take a law kind of thing, to solve every ill. But in regard to audit reform, I hope that you and all the others in the Senate will seize the opportunity that only lawmakers have right now to prevent further harm.

I think, as you have heard—if you look at the sweep of history—the harm from bad financials has been increasing, there is a problem, and it can only be solved by the legislature, by lawmakers.

But the analogue I wanted to make was to the Great Depression and the fact that, with the huge losses of depositors, the Congress recognized the need that the public had to feel that the money they put in banks was safe. It had to be safe and they had to feel it was safe. And the result of that was many laws, maybe too many laws. But the FDIC was created and that law and the safety net for deposits that it provided has been around a long time.

The problem is that since the 1930's, money has migrated out of bank deposits and into the capital markets, from bank deposits to

money market mutual funds and, increasingly, to equities. And with this shift in how the public saves its money, saves its retirement funds, should come a shift by lawmakers in fashioning the kinds of protections that public investors need.

I am not suggesting a safety net under equities. That would do more harm than good. But what I am suggesting is a system that you can help create, indeed, must be the absolute essential element in creating, a system assuring that, when our corporations present their financial condition to the world, what they present is worthy of public trust.

The auditors are the last line of defense. Security analysts, you can fuss with them, but you are never going to fix their conflicts entirely. But auditors are not entrepreneurs. They are the last line of defense. Their job is to vouch for, render trustworthy the financial statements of the corporations they serve in this way, and the public that they serve in this way.

We know in recent years with disturbing frequency the numbers are fudged, earnings are managed, and sometimes, on the slippery slope, they become false and misleading deliberately.

So legislative action is needed now because, with these growing numbers of audit failures, culminating, but not ending, with Enron, the public's trust and confidence has really been badly shaken, just as in the Depression. But now, it is shaken—the public is shaken as investors, not as depositors, and the loss of trust is directed to the reliability of financial statements, not to the bank deposit.

I hope that the hearings will convince Congress that it can and must restore the public's confidence in the financial statements by taking the steps I have outlined to create an effective SRO with independent leadership, which is critical.

Now there has been consideration given to rotation of auditors, and I think that is worth studying.

I thank you for the extra time and I will stop now.

Chairman SARBANES. Well, thank you very much. This has been an extremely helpful panel, not only for your testimony, but also the evident care and effort that went into the prepared statements that have been fully included in the record and which will be subject to careful study.

Senator Gramm has another conflicting engagement. I will yield to him to do his questioning first, and next to Senator Miller, and then I will pick up myself.

Senator GRAMM. Mr. Chairman, let me try to be brief, given your generosity.

First, I want to thank each of you for outstanding presentations.

I believe there is a growing consensus on this Committee that we need to strengthen this independent accounting standard setting board. And so, I want to pose a question to each of you that is counter to the principle that I am moving toward, or at least raising a concern about it.

I think maybe I am the only person who has this concern. The concern basically is, there is a growing recommendation that we need more people who are not CPA's on this accounting board. There is a growing recommendation that we have more independent people involved in the process. There is a growing rec-

ommendation that we give this board unchecked substantial increases in power.

Mr. Wyatt brought up setting standards and talked about political involvement, and I can comment on it because I have consistently taken the view that while some of the proposals of FASB are proposals that I have never been able to understand, not that I think I lack the analytical powers. It is just—the issue about stock options and how they should be treated is an example. But I have consistently taken the position that whatever they decided, it was infinitely superior to anything Congress could decide.

So, I agree with part of the point Mr. Wyatt makes, but not all of it. I have always taken the position that, whether I agreed with the board or not, I did not want to get in their business.

That is the do-no-harm part.

But here's the point. If we create this board and we give it increased power, which I believe we are going to and that I am going to support, does anybody have concern about it losing touch with the reality of the accounting profession? Does anybody have concerns about when we give it financial independence and so it doesn't have to go out and get people to contribute to its support, that we could lose the kind of feedback and input from grassroots accounting that at least I believe is important?

I guess the oldest example of the concern that I am raising goes back to Plato's Republic. The ancient Greek philosophers believed that the solution was to produce perfect men, and then they would be given authority. Our founders understood there has only been one perfect man and that you had to do checks and balances.

But the whole thesis of this board, it raises the question, and I will get to the question, that was raised in response to the concern about Plato's Republic—who is to guard the guardians? Where are the checks and balances? I understand the need for independence. But where are the checks and balances? And do any of you all have a concern that, if we go too far in isolating and insulating this board, that we could create a problem in that direction?

Let me just start over here on the left and we will just go down, if you could give me your response.

Mr. LONGSTRETH. When you talk about the board, you are talking about the FASB. Is that right?

Senator GRAMM. I'm talking about this new successor board that we will give subpoena power, that we are going to give lots of power to. We are going to give them a permanent funding source.

Mr. LONGSTRETH. Okay.

Senator GRAMM. And we are going to give them a lot of power. The concern I have is, that I am raising is, does anybody have concern about the loss of—that they might cease being responsive to the profession, that they might lose touch with people who are actually doing audits every day?

Mr. LONGSTRETH. Yes, I understand. Well, I think the checks and balances that you would build into it would start with very clear oversight by the SEC, just as we have now with the NASD. Of course, you would have constant Congressional oversight because it would be created by Congress and it could be changed or eliminated by Congress. You would have limited terms for the leader-

ship. And I hope that they would be appointed by people who are public officials charged with public responsibility.

Senator GRAMM. You do not want that, believe me.

[Laughter.]

Mr. LONGSTRETH. You do not?

Senator GRAMM. No, I do not think so.

Mr. LONGSTRETH. Well, it is worth a debate.

Chairman SARBANES. Like the Chairman of the Fed, Chairman of the SEC, that panel that appoints the group.

Mr. LONGSTRETH. That is what I was talking about, yes. That is right. Sort of like the Chrysler board that was created. That was an ad hoc board, but it had the comptroller general, it had the chair of the Federal Reserve Board.

I think there should be a committee of public officials who are responsible to the public, the investing public, in a certain way, who would, as a committee, fill the slots and fill the vacancies. They would include, it would seem obvious, the chair of the SEC or the SEC itself, the Fed, the comptroller general, and maybe someone else. And it could have some private-sector people, too.

It seems to me that those are the classic checks and balances we have—limited terms, appointment by other people, oversight by the SEC, including sanctioning powers of the SEC. They can sanction the NASD, and in fact did a few years ago. The same formula.

Chairman SARBANES. Mr. Seidler.

Mr. SEIDLER. I do share your concern. I think one example we have is FASB, which, although it has accountants on it, sits in bucolic Connecticut, almost isolated from the rest of the world and has produced almost other worldly pronouncements in certain cases.

I foresaw in my proposal that the membership of the Board, of the SRO, which I call the National Financial Reporting Board, contain a significant number of practicing professional accountants.

I won't get into the majority/minority issue, but I think we have to look back in history to the old Accounting Principles Board, which did a far better job and contained frequently the top technical partners in the firms who were, as Professor Wyatt has said, also the managing partners of their firm. So, I would like to see substantial representation from practicing or very recently retired practicing.

Chairman SARBANES. Can I invite you to get into the issue of whether substantial means majority or minority?

Mr. SEIDLER. Well, I would think it would be minority because I can see three groups represented. First would be public people. There would have to be people with an overview, I think. Second, I would like to see the financial community represented. And third, the professional accountants, depending on the number that one had and, possibly, at least one member from industry.

Industry has exhibited a great self-interest in the standards——

Senator GRAMM. What do you mean by industry?

Mr. SEIDLER. Representatives like a CFO from a major company.

Senator GRAMM. Okay.

Mr. SEIDLER. Industry has been showing its self-interest. Nevertheless, the preparer community has to have some say over the

structure. So, no, I do not see a majority of practicing professionals, but I see a significant minority.

Mr. O'MALLEY. I would agree with that, Senator. I think history shows us that the failure of the self-regulatory model that we have identified in our panel's report suggests that the tilt toward public interest ought to be weighed, if it is 4–3 or something like that.

I do think you need some very knowledgeable, practicing public accountants who are very much involved in the process because I would fear that if you had too much, if you had a 6–3 or something like that, you could potentially lose sight of what the real issues are to these people out in the field, and that is very important. But at the same time, I am saying, whatever the body is, whether it is created by legislation or by regulation, it ought to have that tilt toward the public interest, for appearance, as much as for the importance of operating it.

Senator GRAMM. You could have a majority that are accountants, but require a super-majority to act. I mean there are a lot of ways that you could do it.

Mr. O'MALLEY. True.

Mr. WYATT. Yes, Senator. I share the concern. I think that we are dealing with a highly technical subject and we need as participants on the board those people who are most expert in dealing with the issues and have a background of having dealt with them. So, I probably would favor a slight majority from the practicing profession, but I could live with a strong minority.

The challenge would be to get people who do not have such expertise to agree to involve themselves in an activity which they had not prepared themselves for in their careers. Getting good people under those circumstances is a challenge.

Senator GRAMM. Would you all see this as a full-time board?

Mr. WYATT. You bet.

Senator GRAMM. So, you would want it to be highly compensated and this would be their only source of income?

Mr. SEIDLER. No, I would demur from that. I am not certain that it should be a full-time board. The FASB are full-time people and they have been divorced from practice and I think that has shown up. I could see a board which functioned to a great extent as a board of directors with a staff under them. I would like to permit practicing technical partners from accounting firms to serve while they are still practicing in their firms.

Mr. BRILOFF. Senator Gramm——

Senator GRAMM. Grab that microphone, if you will, Professor.

Mr. BRILOFF. The question that you ask—forgive me—is what I sometimes refer to as a plumbing problem. Let's first try to think in terms of the overall architecture and if we move consistent with what Mr. O'Malley or Professor Longstreth might have suggested, Professor Wyatt, and think in terms of creating an SRO, I believe that then the personnel and the functioning would fall into place very, very effectively.

The only single standard I would urge, separated absolutely in funding and operationally from the American Institute of Certified Public Accountants because it has become a trade or industry association. It is not any longer a professional organization.

Senator GRAMM. Thank you, Mr. Chairman.

Chairman SARBANES. First, let me say by way of preface to a line of questioning that I want to develop, I feel very strongly, and have for quite a long time, almost since I came to Congress, that the SEC is not given sufficient resources to meet its responsibilities.

We constantly brag about the integrity of the American securities capital markets, how important that is to the functioning of our economic system, that they are the best in the world—and I still believe they are. But the SEC plays an important role in making that possible. Its workload has just grown at a geometric progression. Its staff resources hardly match that.

We passed a package last year that was pressed very hard by industry to reduce trading fees because it was said that they were bringing in a lot more money than the SEC budget, which was the initial rationale for it. We linked that with providing pay parity to SEC employees with the other Government regulators, not pay parity with the private sector, which still remains a difficult problem. But in any event, pay parity with the Government sector.

I think all of us here when we passed that bill, assumed that it would go into place as a package. Well, lo and behold, the fee reduction went into place, but the budget submission from the Administration did not implement pay parity.

The SEC currently has a significant number of unfilled positions because of the budget shortfall. Most people have testified that they think they should have additional personnel over and above what they now have, so that you really do need a significant infusion. Their budget is $460 million—that is the request this year, roughly speaking, for all of the SEC's functions.

So, I have been in touch with the Administration. I have just written to the President again, urging him to send a supplemental request to the Congress because, obviously, and I want to move to this in a moment, we are probing what structure we have, what systemic and structural changes we should make to significantly lessen the risks of these things occurring again. But while that process is developing, it seems clear to me that immediately, additional resources to the SEC would enable it to move ahead and exercise the authorities it now has in order to meet its responsibilities. We continue to press for that. I take it all the panelists agree with the observation that we do need to provide an additional infusion of resources into the SEC to meet its responsibilities. Is there anyone who would dissent from that?

[No response.]

Fine. Thank you very much.

Now let me explore the possible structure. Some of these will be advanced as a devil's advocate. I just want to explore the possibilities. One possibility I guess would be to say, well, the SEC is going to do it all. This would be a major expansion—not what I am talking about here in terms of the budget request I am putting to the Administration. But this would have to be a very significant expansion in personnel and budget and the SEC then would, in effect, set the standards, monitor the standards, really be at the top and carry it on through.

Now the magnitude of this and what it involves may be to some extent illustrated by the testimony we had from Bob Glauber just

yesterday, the Chairman and Chief Executive Officer of the NASD, and I want to quote it for a minute:

> The National Association of Securities Dealers is not a trade association, but, rather, the world's largest self-regulatory organization, or SRO. Under Federal law, every one of the roughly 5,500 brokerage firms, nearly 90,000 branch offices, and almost 700,000 registered representatives in the U.S. securities industry come under our jurisdiction. To give you a sense of our scope and authority, it is vital to know that every brokerage firm in the United States that does business with the public must by law be a member of NASD. We have a staff of over 2,000 employees in Washington, Rockville, and district offices across the country and an annual budget exceeding $400 million.
>
> For more than six decades, our mission and our mandate from Congress has been clear: To bring integrity to the markets and confidence to investors. We do this by licensing and setting qualification standards for industry participants, maintaining a massive registration database that includes qualification and disciplinary histories of all brokers and firms, writing rules to govern the conduct of brokerage firms and their employees, providing investor education and outreach, educating our members on legal and on ethical standards, examining them for compliance with the Federal securities laws and NASD and Federal rules, investigating infractions, and disciplining those who fail to comply. And, of course, violations may result in significant fines or even expulsion from the securities industry.

What is your perception of the idea that we should just have the SEC do it? No one has suggested that here. I just want to get some benchmarks.

Mr. LONGSTRETH. I think that is a completely acceptable alternative. I really do not know whether it is preferable to an SRO for the audit profession.

The truth is that if you go back to the creation of the first SRO, which James Landis, I think, was responsible for as Chair of the SEC, it was the New York Stock Exchange. And as Joel Seligman's book thoroughly and persuasively points out, the New York Stock Exchange, on all issues of fundamental economic importance to its members, beat back reform efforts by the SEC for decades.

The most critical issue was fixed commission rates. The SEC only acted in the face of imminent legislative action to force it to act on May Day of 1975.

So the record was not good from 1933 to 1975 on major economic issues. And it remained very bad with the NASD on the major economic issue right up until the present because billions of dollars of investors' money was lost because there was basically some price-fixing going on which the NASD ignored. That led to the reforms that Senator Rudman led and which made things better. But the record is not great for SRO's in regard to major economic things.

Now what is a "major economic thing" for the audit profession? Well, it could be nonaudit services. That is why I emphasize the importance of the leadership and the way in which the leadership is appointed, to make sure that they really are there on the SRO Board to represent the public interest.

I think having the SEC do it is a viable alternative and one that ought to really work on the question of why isn't that approval a good idea? Maybe you will be led to conclude it is not or that there is a better idea, which is a well-established SRO. That is my view.

Chairman SARBANES. Mr. Seidler.

Mr. SEIDLER. I do not think it would be a good idea. I think that the SEC has demonstrated over most of its lifetime the ability to essentially guide and direct—not always perfectly, sometimes quite imperfectly—the various bodies under its jurisdiction.

With respect to accounting, there hasn't been an SRO, as a practical matter. The SEC's input, frequently by direction, frequently by indirection, has pushed the various accounting standard setting bodies in the direction that the Commission wanted to move. I think the Commission has enough problems in getting resources and I greatly doubt that, given enough resources, it would suddenly undertake for its first time a production function, which is what this would be.

So, I would much prefer to take a model, and I guess that is because I have always tried to copy something that works reasonably well, take a model that does work reasonably well, and that is an SRO under the direction of the SEC.

Chairman SARBANES. Right.

Mr. O'Malley.

Mr. O'MALLEY. My own sense is they ultimately are responsible anyway. The SEC will be over any SRO or any other organization that is set up to respond to these concerns. My own sense is that I would talk to them first and see whether they can feel they can do it best this way or with an SRO. I don't have any particular preference. I just want to make sure that all the issues—whether it is discipline, standard setting—all of these issues get somehow covered by an oversight body, whether it is created by SRO or created under the SEC, with continued Congressional oversight of the SEC, would be acceptable to me.

As long as we get these subjects taken care of in the group, I do not care how it is constructed, to be honest with you, Senator.

Chairman SARBANES. Right.

Mr. Wyatt.

Mr. WYATT. I think I would prefer to have the standard setting be independent and everything else be under the aegis of the SEC.

The FASB and the SEC work together very, very closely currently and I would see them continuing to do so. But I think that having an independent body removes to some extent the political influence, and I think that is important.

Chairman SARBANES. Professor Briloff.

Mr. BRILOFF. I would not want to have the responsibility that we are here talking about directly under the SEC. The SEC is the over-arching body for the administration of the nexus of securities laws, not only the 1933 and 1934 Acts.

I would look to the SEC as possibly saying to the accounting profession, under the FCPA 1977 Act, you are required to implement the internal control procedures. Under the 1995 Act, you are required to do that even more fully. Go out and do it.

I would look to the SRO for that registry and the disciplinary process that we have been talking about, with the SEC there as the others have indicated, as the over-arching body, just to see that all of these bodies are functioning optimally.

Chairman SARBANES. All right. That is at one end of the spectrum. Now at the other end, we have had this system of voluntary effort, which I think everyone indicates has obviously had significant deficiencies in it. It really is falling short.

I am struck by the quality of the reports by the various commissions, yours, Mr. O'Malley, and much earlier, the Cohen Commis-

sion. And yet, our inability to implement or put into place most of the recommendations.

We get a problem and we do a commission, we do a very good study, we get very able people to draw these conclusions. And then the recommendations are out there and a few get put into place. But in terms of instituting some system or structure that really addresses the problem, we seem to be unable to do that.

Mr. O'MALLEY. Senator, we were very aware of that problem and I think attendant to it. We thought that if the POB, which was our proposal, was so strengthened and empowered to carry out this mission, that one of the things that we would require them to do, was to regularly report on whether these recommendations had been implemented, and if not, why not, and to publicize that information in our annual report, so that the public, the Congress, and everybody would know exactly whether or not the profession was responding to these proposals.

That had been agreed upon. And I am not sure that was in the charter, but the POB agreed that was an appropriate way to go. They would oversee whether these recommendations were being implemented and report publicly on the status of that.

Chairman SARBANES. First of all, I take it that you all think it would need to be done by statute and not by regulation by the SEC. Is that correct?

Mr. O'MALLEY. I am neutral, Senator. I do not know which would be better. If the SEC can do the job, as far as I am concerned, that is fine. If an SRO can somehow do it better, that is fine.

Chairman SARBANES. Of course, they have been unable to do it up to this point. That is one of the problems, I think.

Mr. Wyatt made the point that, and I think it is a very well taken point, that you had Members of Congress who had intervened with FASB as they were prepared to do some standard. I would just make the observation that that wasn't a spontaneous intervention. It is not as though Members of Congress sit around and try to keep tabs on what FASB is doing and then decide that they want to intervene. They are intervening because they are hearing from elements of the industry who are resistant to what FASB is thinking of doing. And the same thing with the SEC.

Levitt was thinking of instituting certain things, and then there was a big outcry about that, both from the industry and from the Congress. But the Congress was really, at least those who moved ahead, were reflecting what they were hearing from the industry.

So it seems to me that we have to get a change in attitude at the top within the accounting profession in terms of where their responsibilities lie. One of the challenges is, how do we achieve that?

Mr. SEIDLER. Could I comment on that?

Chairman SARBANES. Let me just say one thing about the NASD because I want to come back and ask you to what extent you think they have done a good job and should constitute some example or benchmark that we should look to as we think about this problem.

Mr. Glauber, in his testimony, said:

> On average, the NASD files more than 1,000 new disciplinary actions annually, with sanctions ranging from censures to fines and suspensions to expulsions from the securities industry. We supplement our enforcement efforts with referrals to criminal authorities and the SEC. In one important settlement alone this year, reached jointly with the SEC, the NASD, and the SEC each imposed sanctions of

$50 million against a major investment bank for violating SRO rules by extracting illegal paybacks from favored customers to whom it allocated "hot" IPO's.

Is the NASD a model to which we should pay some attention as we address the issues that we are confronting here?

If I could get quick answers from everyone.

Mr. LONGSTRETH. Yes, I think it is. It is a model which has been vastly improved through the Rudman recommendations and changes. NASD Regulation now, I think, is much better structured to represent the investor interest as opposed to the interest of the brokerage community.

But just to answer the earlier question which is relevant to this question, I do not think the SEC has the power to create the kind of SRO that you would want to create to assure effectiveness. Maybe I am wrong about that, but I do not think it does.

Of course, you could empower it. And I would think if you are going to have an SRO, one way to do it is to tell the SEC largely what to do, and the other is to empower them to do it in their own best judgment, with some broad principles.

I do think that the NASD is vastly improved. But any SRO serving the fundamental economic interest of its members is going to have a struggle between that self-interest and the public interest. However, as long as one recognizes that and works against it through publicity, transparency, and so on, it seems to me that an SRO can be an effective tool.

Chairman SARBANES. Mr. Seidler.

Mr. SEIDLER. I think Mr. Wyatt referred to the impact perhaps of greed on the accounting profession, going into too much consulting. I worked on Wall Street for a large part of my career. The greed in the accounting profession, by comparison to the greed on Wall Street, looks like Little Red Riding Hood.

The NASD has dealt with a group of people who are intent on making a great deal of money and overall, has done a very good job of controlling that.

If you see the size of the problem, the number of people they have dealt with, they have, I think, done quite an effective job with a very, very difficult problem.

I was in charge of Bear Stearns internal audit department for some time and also sat on the operating committee, and therefore, saw the interface with the NASD. Was it perfect? No. Did they always control this perfectly? Probably not. But they did constantly cause us to change, to operate, to see what they were doing, and to respond.

In general, I felt that this model was quite effective and I would see it applying, in some sense, easier to apply it to the accountants than it would be to a bunch of my partners in Bear Stearns.

Chairman SARBANES. Mr. O'Malley.

Mr. O'MALLEY. Senator, you mentioned discipline and I think that was one of the keys in our report, the total lack of discipline in the existing organization of the profession.

I do not know what the best answer is for making sure that there is discipline and that the justice is swifter than it had been in the 8 or 9 years that it takes today.

But I think, if I can just say, on accounting standards, we think that should be essentially an independent body, but with oversight

by this new body, whatever the organization is. And the same thing with auditing standards. That should be put together by experts that are relatively independent. This oversight group would be appointing the chairman, approving other appointments, and overseeing in the sense that they would be telling them you are not moving fast enough or addressing this problem. But those two standard setting bodies should be relatively independent in setting the standards, but with oversight from this body. The key for this body is going to be the discipline because that to me brings back my favorite subject, and that is improving audit quality.

If you put some teeth in the discipline, I think it is going to help overall in the improvement of audit quality.

Chairman SARBANES. Well, who is doing the monitoring of the standards under your scenario?

Mr. O'MALLEY. Monitoring would be this group. But the standard setting itself would not be done by this group.

Chairman SARBANES. Does everyone agree with that or can you bring the standard setting into the group as well?

Mr. SEIDLER. We have, for example, NASDR under the NASD. I would see the SEC practice section perhaps being like NASDR.

I would see the FASV as another subsidiary of this board. The auditing standard setting as yet another subsidiary, each one developing its own standards but under the direction, selection of leadership, control——

Chairman SARBANES. Monitoring.

Mr. SEIDLER. Monitoring—of the overall board.

Chairman SARBANES. So the overall board would have under it the sub-boards or sub-groups that established the standards and also, whatever group did the monitoring of the standards and the disciplining. Is that correct?

Mr. SEIDLER. That is correct.

Chairman SARBANES. All right.

Mr. Wyatt.

Mr. WYATT. Yes.

Chairman SARBANES. Why don't you speak now and then we will come back to Professor Briloff. I know he has something to offer to this discussion.

Mr. WYATT. Let me start by saying, I am not as familiar with the NASD as obviously the fellow on my right is. But a structure that would permit the expertise needed to set accounting standards and auditing standards to function properly, the failure we have had, I believe, is more in the area of disciplinary action.

The AICPA disciplines, I do not know, hundreds, maybe thousands, of practicing accountants every year, but they are single practitioners. They haven't done anything with the bigger firms, I suspect, partly at the risk of losing the revenue from all of the members of those firms who are members of the institute. I don't know, but that is my perception. That has to change.

Chairman SARBANES. Professor Briloff.

Mr. BRILOFF. The only comment I want to make is that I would like to have the standards themselves left to those within the profession. I believe that is part of their professional undertaking. However, this SRO would act as a mandate under the Congress or the SEC to make certain that the profession has, in fact, fulfilled

the responsibilities vested in it, whether by the Congress or by some mandate from the SEC.

What I am driving at here is, as I indicated earlier, and forgive me for repeating, we have the Foreign Corrupt Practices Act and Title III of the 1995 Act, which the profession has blithely essentially ignored. If there were an SRO, it would direct the profession to take cognizance of it and to then make certain that the profession is responding meaningfully and effectively to what the legislation anticipated.

Chairman SARBANES. Now, I am struck by the fact that under the current arrangements, the standard setting bodies, both FASB and the international, because we do have this international dimension now developing, and I think we need to keep an eye on that. But they are funded by basically going around with a tin cup. So, you go to the very people who are going to be most intimately affected by the standards. You ask them for money to support the operation, and if they do not like what they think the standard setting body is going to do, they are obviously either unwilling or reluctant to give money.

It was dramatized when Volcker was soliciting a number of the largest corporations to give contributions for the International Accounting Standards Foundation, to fund that work. And amongst the companies that was on the list that was solicited was Enron. Then, internally, within Enron—Paul Volcker knew nothing about this. They were passing memos back and forth trying to decide whether to make a contribution. And the big question was, what kind of influence could this get them in whatever standards were going to be set.

What are your views on how we should fund this SRO, so you are not dependent upon the voluntary contribution of the people in the industry that are being affected, either by the standards or by the monitoring or disciplinary action?

Mr. LONGSTRETH. The NASD's $400 million budget is paid, I believe, through members—the catch is that everybody who hangs out a shingle as a broker-dealer or registered representative, has to be a member.

Chairman SARBANES. And they have to pay a fee.

Mr. LONGSTRETH. They have to pay a fee.

Chairman SARBANES. Right.

Mr. LONGSTRETH. I guess that adds up—you said $400 million—almost as much as the SEC.

Chairman SARBANES. Right.

Mr. SEIDLER. I would see every company's securities that are publicly-traded having to pay a certain amount and every auditor or auditing firm that was registered to audit such companies also paying a mandated fee.

Mr. O'MALLEY. Something like that, some kind of a fee structure.

At present, the FASB is funded—each of the major accounting firms contribute something like a million dollars to the FASB, and then industry essentially makes up the rest of the FASB's budget.

So in the final analysis, it is going to be the companies that are registered that are going to pay the cost, whether it is through fees or through indirectly the charges they pay to the auditing firms.

Chairman SARBANES. Yes.

Mr. Wyatt.

Mr. WYATT. I would disagree with my colleague. The FASB's budget, the last I saw, was approximately two-thirds from the sale of publications.

Chairman SARBANES. Right.

Mr. WYATT. And one-third from these contributions from accounting firms and industry.

Chairman SARBANES. Of course, the International Standards Board, the Europeans have indicated, the EU, that by 2005, they expect to adopt the standards of the International Accounting Standards as their accounting standards in the EU countries, which I regard as a significant development because this is a very significant economic actor, the EU community. Its economy combined is almost equivalent to the United States. When they do that, they won't be able to charge for materials because the EU is taking the position that the materials—since these are requirements that you have to meet, you ought to get the materials without paying for them, in order to abide by them.

Mr. WYATT. Different mindset over there.

Chairman SARBANES. Yes.

Mr. WYATT. I think that the defect in the FASB structure currently is that the trustees fundamentally are representatives of the groups that are paying in the money. The trustees of the foundation should not be representatives of those organizations, but should be people from the public who have independent interest. I think that is where part of the problem with the FASB has rested.

Chairman SARBANES. Professor Briloff, did you want to add anything to this point?

Mr. BRILOFF. Very little at this point. Any one of these funding mechanisms would work, either charging for those who are registered, the registrants, or the firms.

Again, forgive my applying that notion of "a plumbing problem." I want to resolve the matters in principle, spelled with an "l-e," and everything else will fall into place.

Chairman SARBANES. Yes.

Mr. Seidler.

Mr. SEIDLER. Mr. Chairman, if I could add one caveat.

There are many smaller public accounting firms that have several public companies whose securities are traded. Their main practice is private, but they have a few.

In recent years, with the increasing problems of dealing with new pronouncements and so on, there has been a tendency for them to drop that business, to find that it is just too difficult to handle. I would hate to see those smaller accounting firms stifled by a new structure.

So to the extent that it is possible, it would be useful to keep the structure, particularly fees, in such a way as to not force out this body of smaller accounting firms. Some of them are very excellent in specialties, sometimes better than the major firms.

Chairman SARBANES. Well, that is an interesting point. We will have to wrestle with it. But it seems to me that there is a significant break between accounting firms that take on publicly-listed companies because the nature of their responsibilities at that point, very significant dimensions are added to it, as opposed to just han-

dling private companies. In fact, we had a discussion in here yesterday with a panel about that very subject.

The American Institute of Certified Public Accountants is putting out an alert now to all their key people about the terrible things that may happen here in the Congress as we wrestle with this problem and how they have to start contacting their Representatives and their Senators to begin to build a groundswell in the other direction.

One of the points they make is that the very small accounting firms with private clients are going to be impacted by all of this. Of course, the level at which we are thinking has this kind of differentiation point between private and public. But once you start representing companies that are listed on the exchanges, which then gets you into questions of the integrity of the capital markets and the reliability of the information, and all the rest of that flows from that, it seems to me that you are dealing in a different realm.

Now, we will have to look at that. The danger, I think, is any exception becomes the loophole that is then exploited and is broadened and widened, you see. And all of a sudden, you have undercut what you are trying to do. But I think it is a reasonable point and it is one we will have to consider.

I think then we will draw it to a close.

Everyone seems now to agree that at least some of the consulting activities that accounting firms are doing, while also doing auditing, ought not to be done. Now some take the position that they should not do any of those activities at all. Professor Briloff has held that position today. Others have held it before the Committee in the course of our hearings. Others say, well, certain things should be precluded, but not everything. And then the question is, how do you define that?

In the Superior Bank failure in Chicago, which this Committee has been looking at, the accounting firm established the internal financial process of the company, of the bank, by which they would value residuals. Then in the auditing function, approve the company's valuation of the residuals developed by their process. Now, of course, it turned out they were grossly overvalued and it was one of the reasons why the bank collapsed and it is now going to cost the insurance fund probably somewhere around $500 million. Who should draw this line in the structure we are talking about?

Mr. O'MALLEY. Senator, could I respond to that?

I think, and this is a little historic, the SEC, working with the profession, set up the Independent Standards Board. And that Board, Chaired by William Allen, who was a former head of the Delaware Chancery Court, set up a structure for resolving independence issues. They listed what the basic principles of independence were. They listed all the threats to independence, and they set up a system for evaluating and addressing the threats and then taking some services and saying, they clearly should be off the table, others should not.

The basic principle is that you shouldn't be self-auditing. You shouldn't be able to audit your own work. And that would address the issue you raised in the Superior Bank situation.

The other is that you cannot be part of management. You cannot replace management or then you clearly are not independent both in form or in appearance or in substance.

So the SEC, when it announced its rulemaking initiative, essentially ended the life of the Independent Standards Board, which it had set up just 2 years before. And this group did a lot of valuable work. I said in my written statement, I would hope, however we resolve this issue, that the principles they set up, which were a clear and positive guide for regulating independence, be utilized by the new body going forward and making these decisions.

And I would emphasize, I do not think we ought to have legislation that says you can do this service and you cannot do that service. This body should make those decisions and they should do it based on a sound conceptual framework.

Chairman SARBANES. Should you have legislation that didn't try to set the specific line, but try to provide some broader guidance to where they might go?

Mr. O'MALLEY. That would be totally acceptable to me. If we had a conceptual framework that said you cannot audit yourself, you cannot be part of management, that addresses any threat.

Chairman SARBANES. A general statement.

Mr. O'MALLEY. Yes, exactly.

Chairman SARBANES. But then to be developed out.

Mr. O'MALLEY. Exactly. That would be my approach.

Mr. LONGSTRETH. I would agree with that.

Chairman SARBANES. Okay. Yes.

Mr. LONGSTRETH. Shaun and I have talked a lot about this subject together. I just want to add one comment to what he said, most of which I agree with.

I think I have read all of the ISB stuff. The big hole in the SEC rule which I described, namely, that it fails to acknowledge that large, nonaudit fees, for whatever kind of nonaudit services might be involved, can have an impact on independence.

But the SEC did not say so and neither, as far as the ISB got, did the ISB. I do not think there is any recognition there of that fundamental, common sense observation. The point at which large amounts of money are paid to you for services that management could send elsewhere, could retain other people put at risk for one's professional reputation, which can be subordinated to the amount of fees being paid and the annuity that those fees can represent.

The prospect of fees, in the case of Enron, who paid Andersen $27 million in 2001. So $27 million this year. But you can look forward to that kind of payment far into the future. That is a principle I would add to the two very important principles that Shaun mentioned as being developed by the ISB.

Mr. O'MALLEY. I would only add to that point that, to me, it doesn't matter what service you are being paid for. If you are being paid—whether it is auditing or another service—there is an inherent conflict in the relationship to begin with. If you are being paid $20 million to do an audit and you are going to be doing the audit for some years, it is no different than if you are being paid another $5 million for another service.

To me, the inherent conflict is there. I think it is up to the structure of this oversight board to make sure that the audit committees

are deeply involved in any nonaudit service decisions, as long as we have eliminated self-auditing and acting as management.

Chairman SARBANES. But this could be a handy benchmark. If the nonaudit services, in terms of recompense, dwarf or overwhelm the audit service, even if they are for services that we generally have said, do not create your problem, they are okay services. But somehow, the size and the magnitude of them grows to the point that the recompense dwarfs the other, then you may have created a problem. Perhaps some kind of percentage test or something at least avoids that more extreme or egregious situation.

Mr. O'MALLEY. I agree. I saw the one case that was cited. I do not know what the company was, where the auditors were paid $3 million for the audit and $60 some million. And to me, I would imagine that would be eliminated by this agreement not to do major financial systems design and implementation. That is where the big dollars are. They have taken that off the table entirely. But I agree with you. In that instance, if I were on the audit committee, I would be saying, wait, wait a minute on this. Let's see if we can get some other proposals.

Chairman SARBANES. Let me ask you about auditor rotation, if I could, or term-limited auditors, or however you want to describe it. Actually, we have received some interesting testimony, including from former chairmen of the SEC who have really advanced the 5 or 7 year rotation for auditors. I would just be interested to get your quick reactions to that.

Mr. SEIDLER. The Cohen Commission examined it and concluded considering economic and noneconomic costs and benefits, that the costs were greater than the benefits and said not to have rotation. On the other hand—that was 25 years ago. That was 25 years before audit fees grew and before we had some cases that we had recently where we see the influence of the fee and the influence of a simple question—would you like to be the audit partner who lost the XYZ audit, getting greater and greater.

The one factor in favor of rotation is, when the auditor says, no, you cannot do it, and risk giving up the fee, he's not giving up this year's fee, he's giving up the stream of future fees. If there were auditor rotation, he would be giving up a finite stream of future fees, if it were a 5 year or 7 year rotation.

I was silent on it because I could not come to a conclusion. But there is no question that if we did have rotation, that evil would be cut tremendously. On the other hand, changing auditors involves a lot of other evils, one of them being, as we discovered, most frauds occur in the early years of the audit. It does take a while to learn about the business. So it is almost a toss-up.

Mr. O'MALLEY. I would say, I am 6 years out of doing audits, but I am still opposed to auditor rotation, Senator, and I think for good reason. One of the keys to being a good auditor and we heard this today, is looking at the whole business, understanding the whole business, the culture, the systems, the people, what is going on.

To do that, you have to be in place for a period of time. I think the way to deal with this, and some companies already do that, they require the auditors to repropose regularly for the audit, to submit a proposal to be continued as auditors. Sometimes that is done in competition with other firms where they are reproposing

and other firms are proposing against them. I think it is the responsibility of the audit committee to satisfy itself that you are getting the kind of service that you need and then deciding whether to go ahead. That decision to reappoint auditors should be taken very seriously. I think in my experience on audit committees, it was taken very seriously. I would be against rotation of auditors.

Mr. BRILOFF. Mr. Chairman, at one time I was very much opposed to the rotation of auditors for various reasons. But I am now very much in favor of it, particularly as we look upon these audit fiascoes, we all too frequently find the incestuous relationships that prevail. Namely, members of the auditing firm becoming CFO's or importantly positioned as management people within the firm that had been the subject of the audit. So there is too much of that buddy system. We had it in Enron. I saw it in the CUC situation in Cendant.

Therefore, I am in favor of the rotation now. And that brings to mind an observation made by Jack Seidman, one of the profession's greats, who made it probably 35, 40 years ago, who referred to the fact that Mrs. Seidman was a most meticulous housekeeper. But he said, when she expects company to be coming, she is especially so. The house is even more effectively kept.

[Laughter.]

So it is that if a firm expects that they will be superceded 2 or 3 years down the line, they try as much as they can to make sure that they are leaving with a clean slate.

Chairman SARBANES. Thank you.

Mr. LONGSTRETH. I would like to second the point that was just made. One way of thinking about it is that the centerpiece of such self-regulation as has existed has been the peer review, where one of the Big 5 reviews another Big 5's audit.

That has not been thought of as a great success in the sense that there has never been much of a problem found. That is because what goes around comes around. There are only five firms and it is not likely that, unless something terribly bad is found, that they are going to slam their colleagues.

So the most effective peer review we could have would be a peer review that results basically from a new auditor coming in through rotation with the old auditor having a sure knowledge that a new auditor is coming in. I think the balance that Dr. Seidler put on this on the pros and cons leading him, I guess, to not making a clear decision in his own mind at this point is where I am, too.

I think there are some powerful arguments to consider this now, given the growing risks that we face through nonaudit services. It is one possible solution anyway, to the problem of trying to limit nonaudit services that ought not to be limited because there is so much synergy involved in using the auditor.

It deserves a lot of close study, but I am not in a position to come out one way or the other at this point.

Chairman SARBANES. Well, this has been an enormously helpful panel and we appreciate it very much.

This hearing stands adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SHAUN F. O'MALLEY

CHAIRMAN, 2000 PUBLIC OVERSIGHT BOARD PANEL ON AUDIT EFFECTIVENESS (O'MALLEY COMMISSION)
FORMER CHAIRMAN, PRICE WATERHOUSE
PAST PRESIDENT, FINANCIAL ACCOUNTING FOUNDATION

MARCH 6, 2002

Thank you for inviting me to testify before the Committee about the important decisions facing the accounting profession, its regulators, and the Congress.

I am Shaun O'Malley. I spent 36 years working in the accounting profession, the last 7 of those as Chairman of Price Waterhouse until my retirement in 1995. Since that time, I have served on various corporate and nonprofit boards and audit committees. In 1998, I was asked to serve as Chairman of the Panel on Audit Effectiveness, which was appointed by the Public Oversight Board (POB) at the request of the Securities and Exchange Commission. The Panel was asked to conduct a comprehensive review and evaluation of the way independent audits are conducted and to assess the effects of recent trends in auditing on the public interest.

The Panel was formed in the wake of a number of high profile restatements, which were followed by massive declines in market values of the companies involved. Concerns were raised at that time about the overall reliability of financial statements and, in particular, about the role of auditors. On August 31, 2000, the Panel issued a report in which we made a number of significant recommendations aimed at improving audit quality.[1] I will address what I believe to be the Panel's key recommendations later in my statement.

The Enron debacle has been the catalyst for a reexamination of current methods of corporate reporting and audit oversight. While my testimony will focus primarily on the latter, I first want to comment on the specific issues highlighted by the Enron failure.

Failures in the Corporate Reporting Safety Nets

There exist numerous safety nets in the corporate reporting process—corporate management, the board of directors and audit committee, law firms, auditing firms, securities analysts, capital providers and intermediaries such as commercial and investment banks, credit rating services, the Financial Accounting Standards Board, and the Securities and Exchange Commission. Most, if not all, seemed to have failed in the case of Enron. We need to examine what caused these shortcomings and decide how to remedy them.

As far as I can tell from Congressional testimony and press coverage to date, the overriding cause of the Enron failure can best be identified as "systems breakdowns." Practically every element of our system of safeguards failed until it was too late to repair the damage. The list of breakdowns is a long one. It includes:

- The apparent willingness of a number of Enron employees to set aside their responsibilities and to manipulate the numbers, subvert control systems, and mask the true status of Enron's financial condition and performance.
- The apparent willingness of certain senior management personnel to promote off balance sheet activities for personal gain at the expense of the shareholders, employees, and creditors.
- The apparent failure of Enron's Board of Directors and of its audit committee to understand what was happening inside the company; their corresponding willingness to accept, without more penetrating inquiries, management and auditors' assurances that accounts were properly stated; and their willingness specifically to waive the company's own ethics rules in order to permit some of the now-infamous off balance sheet transactions involving company insiders.
- The apparent failure of the auditors to detect irregularities and/or their apparent willingness to support transactions and related accounting and disclosures that do not stand up to scrutiny.
- The unexplained waiver by the SEC of important disclosure requirements for Enron on two occasions, and the Commission's failure to review Enron's financial statements for several years despite an announced step-up in annual report reviews and despite Enron's huge growth and its position as one of the top 10 U.S. companies as measured by revenues.
- The failure of the FASB and the SEC to promulgate timely accounting and disclosure requirements in the face of ever-changing and increasingly complex business

[1] The Panel on Audit Effectiveness, Report and Recommendations, August 31, 2000 ("Report").

transactions, the growth in the use of derivatives, and the increased use of off balance sheet partnerships and special purpose entities.

- The apparent affirmation of some of the special entity off balance sheet transactions by the attorneys retained by Enron's chairman.
- The financial analysts' apparent failure to understand adequately Enron's business, financial statements, and results, which led to their recommending the purchase of Enron stock virtually up to the moment of the company's collapse.
- The lenders' apparent failure to gain an accurate picture of Enron's true financial position and operating results, while extending large amounts of credit to the company.
- The apparent failure of debt rating agencies to understand Enron's precarious position until it was too late.

In short, just about every element of our financial system's safeguards failed for an extended period of time, often until the final collapse of the company.

In light of this widespread breakdown of our systems of control and regulation, there is a need to address each element of the system with the goal of repairing what appears to be broken and strengthening controls, accountability, and responsibility. I will leave the task of repairing most of these elements to others and will restrict my recommendations to issues affecting the accounting profession and its governance and oversight.

Role of the Accounting Profession

Accurate financial reporting has long been viewed as the bedrock of strong capital markets. Investor confidence in the reliability of financial statements lowers the cost of capital and increases the effectiveness of the capital markets in allocating resources. Enhancing the effectiveness of audits is key to improving the reliability of financial statements.

In this regard, the primary goal of the Panel on Audit Effectiveness, which I chaired, was to thoroughly review, evaluate, and recommend improvements to the way independent audits are performed and to assess the effects of recent trends in auditing on the public interest. The Panel was appointed in the fall of 1998 by the POB at the request of the SEC. It included retired and active leaders in the audit profession, two former SEC Commissioners, and a staff of experienced auditors.[2] Pursuant to the SEC's charge, the Panel undertook a detailed study of the effectiveness of audits, the impact of nonaudit services on auditor independence, and the adequacy of the auditing profession's current governance system.

Over a period of 2 years, the Panel's investigation encompassed a wide range of activities. Its principal effort was its Quasi Peer Reviews, which were in-depth reviews of the quality of 126 audits of SEC registrants in 28 offices of the eight largest accounting firms. In addition to the engagement reviews, meetings with two focus groups were held in most of the 28 offices—one with senior accountants/auditors and the other with audit managers, most of whom work on audits of public companies. This process also included in-depth interviews with the partner-in-charge of the office's audit practice. Panel members attended most of the Quasi Peer Reviews, and the Panel staff planned and directed all of them. The Quasi Peer Reviews were a major source of the Panel's findings and recommendations for improving the conduct of audits.

The Panel's other activities included:

- Focus group meetings with chief financial officers and controllers, internal auditors, peer reviewers, and representatives from the eight largest firms.
- Regular meetings with the Office of Chief Accountant of the SEC throughout the Panel's work to report progress.
- A survey requesting opinions on issues of audit effectiveness, distributed to over 500 selected individuals and organizations representing a very wide range of constituencies.
- Public hearings in the early stages of the Panel's work at which 21 organizations testified, including the SEC, auditors, financial statement preparers, analysts, plaintiffs' and defendants' attorneys, standard setters and educators.
- Reviews of the eight largest firms' audit methodologies, policies and procedures, manuals and other guidance materials, risk management information, professional development activities, and policies and procedures for recruiting, evaluating, compensating, and promoting audit personnel.
- Meetings with representatives of various private sector bodies involved in the governance of the profession.

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[2] *See* September 28, 1998 letter from Lynn Turner, Chief Accountant of the SEC, to A.A. Sommer, Chairman of the Public Oversight Board, Report, Exhibit 1.

- Research, with the assistance of the SEC staff, into the causes and circumstances that led to recent SEC Accounting and Auditing Enforcement Releases.
- Analysis of academic, professional, and regulatory literature on the effects of nonaudit services on auditor independence.
- Studies of the profession's current governance structure and analysis of alternatives.
- Collection of information on recent international initiatives to strengthen audit effectiveness on a global basis.
- Further public hearings on the May 31, 2000 Exposure Draft of the Panel's Report and Recommendations at which 18 organizations testified including the SEC, the auditors, the State boards of accountancy, professional organizations, standard setters, and educators.
- Analysis of 42 comment letters received on the Exposure Draft.

On August 31, 2000, the Panel issued its findings and recommendations, copies of which have been provided to each of you in advance of today's testimony.

The Panel concluded that "while many specific recommendations . . . for improvements in the conduct of audits and the governance of the profession" are necessary, "our report demonstrates that both the profession and the quality of its audits are fundamentally sound."[3] This remains my opinion today, although the aforementioned totality of breakdowns in the Enron situation underscores the need to accelerate implementation of many of the Panel's recommendations.

Of the more than 250 pages of its report, the Panel spent three full chapters discussing a host of recommendations targeted to furthering audit quality. Let me emphasize that, at the end of the day, the goal of enhancing audit quality has to be the primary goal of both private and public sector responses to the problems that Enron and other recent failures highlight. It is a matter of concern to me that, in the context of audit reform, so little is being said in the media about how the various proposed solutions will improve audit quality. Yet that is the issue upon which we must ultimately focus our attention if something positive is to come out of these unhappy events.

The recommendations of the Panel, made prior to Enron's collapse, bear some similarity to many of the proposals discussed in Congressional hearings over the last 2 months, as well as the proposal announced by the SEC. In my testimony, I will describe the thrust of the Panel's recommendations in the context of three themes recurrent in post-Enron proposals for reform: (1) the need for improved audit quality; (2) the call for separation of audit and nonaudit functions; and (3) the proposals for change in the governance of the auditing profession.

The Need for Improved Audit Quality

Although the Panel found that an overwhelming majority of the 126 audits it studied were of a high caliber, the Panel also found significant room for improvement in the audit process. Indeed, the Panel made some 150 specific recommendations toward furthering the quality and reliability of audits. I do not intend to discuss each of these recommendations today, many of which pertain to the application of detailed auditing standards. However, I will discuss a number of areas in which I believe the Panel's recommendations were most significant.

New Audit Approach to Detecting Fraud—"Forensic-Type" Procedures

The Panel found that the risk assessment and response process called for under existing Generally Accepted Auditing Standards (GAAS)[4] "falls short in effectively deterring fraud or significantly increasing the likelihood that the auditor will detect material fraud, largely because it fails to direct the auditing procedures specifically toward fraud detection."[5] Rather, an auditor's duty is to report fraud if it is discovered,[6] but not to search actively for it. Such a policy reflects the practical limitations on an auditor's ability to investigate. The enormous cost inherent in uncovering the

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[3] Letter from Shaun O'Malley to the POB and Other Interested Parties, preceding the Report.

[4] Beginning in 1948, the membership of the American Institute of Certified Public Accountants (AICPA) adopted 10 statements referred to as "Generally Accepted Auditing Standards" or GAAS. The Auditing Standards Board (ASB), a senior technical committee of the AICPA, has responsibility for interpreting GAAS through Statements on Auditing Standards (SAS's). The SAS's and the 10 GAAS statements are referred to collectively as Generally Accepted Auditing Standards. Report at 2.3.

[5] Report at 3.46. *See* SAS 82.

[6] An auditor also may have a legal obligation to report fraud to the audit committee and, ultimately, to the Commission under certain circumstances. *See* Section 10A, Securities Exchange Act of 1934, 15 U.S.C. 78j–1.

presence of fraud is rivalled only by an auditor's lack of the means to do so (that is, the power to subpoena).

The Panel concluded, with respect to the matter of fraud detection, that a very dramatic shift in auditors' approach to their audits is not only possible, but also necessary. Thus, the Panel recommended that GAAS require auditors, in planning and performing certain phases of their examinations, to suspend the neutrality of their professional skepticism and presume the possibility of dishonesty at various levels of management, including the possibility of collusion.[7] The Panel further recommended a number of specific forensic measures that should be taken during any audit, with the principal objective of detecting material financial statement fraud.[8] The Panel believed that this new approach to audits would not only help to discover material fraud before its effects are felt by the market, but would also more likely deter fraud from occurring in the first place.

It is important to note that, even in the event that the Panel's recommendation is adopted, an auditor's ability to investigate fraud will always be limited. Auditors do not possess the power to subpoena documents or testimony, nor are auditors trained experts in the identification of falsified documents. Moreover, clients will not pay auditors for the enormous labor and resources inherent in even the simplest SEC-style investigation. That said, it was the opinion of the Panel that the recommended approach would have a significant impact on the profession's ability to safeguard our markets from fraud.

In this connection, last week, the Auditing Standards Board issued an Exposure Draft which would, if adopted, replace the current audit standard relating to fraud. I am reviewing the proposal to determine whether it will accomplish what the Panel sought to achieve in its recommendations in this area.

Adopt Clearer and More Specific Audit Standards

All auditors are required to perform audits in accordance with GAAS promulgated by the Auditing Standards Board (ASB) of the AICPA. The SEC historically has accepted GAAS as necessary and sufficient to comply with the requirements of the securities laws that call for independent audits of financial statements.

The Panel noted that the guidance given to auditors in the Statements of Auditing Standards (SAS's) issued by the ASB lacks imperatives that compel auditors to take definitive steps in specified circumstances. For example, in some cases an SAS may indicate what an auditor "should" do, while in other cases a SAS might only indicate what an auditor "should consider," allowing significant latitude for the exercise of judgment based on the circumstances of the engagement and on the auditor's assessment of risk and materiality. The Panel believed that auditing standards must provide both reasonable and measurable benchmarks for performance by auditors.[9] Therefore, the Panel urged the ASB to modify, to amend, or to improve its standards by making them more specific and definitive.

The Panel also noted that the ASB and its staff issue audit standards and guidance in various, sometimes conflicting forms—that is, standards, interpretations, audit guides, auditing practice releases, statements of position—without establishing a hierarchy of authority to guide in their application.[10] Without such a hierarchy, auditors find themselves searching for a rule among competing guidelines issued by any number of committees and subcommittees. In response to this problem, the Panel recommended that the ASB define a hierarchy of GAAS and collect existing guidance in a readily accessible source.[11] The ASB has since issued an SAS covering the hierarchy of GAAS.

Require Auditors to Obtain a Deeper Understanding of the Issuer's Business and Related Internal Controls

The Panel recommended that auditing standards "require auditors to possess a far deeper understanding of the entity's business processes, risks, and controls" than is currently called for under GAAS.[12] This is particularly important, given that today's businesses are far more complex, often technology-based, and global in scope than ever before.

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[7] Report at 3.51.
[8] *Id.*
[9] Standards need to be reasonable in that they should not force auditors to adhere to rules that do not take into account the myriad of circumstances that may exist on audits. To serve as effective measures of the quality of performance, however, auditing standards need to provide clear, concise, and definitive imperatives for auditors to follow.
[10] Report at 2.220–222.
[11] Report at 2.232.
[12] Report at 2.26.

In order to plan and conduct an effective audit, an auditor must have a full understanding of an issuer's business and internal controls,[13] particularly its information systems. An understanding of the internal controls of an issuer helps an auditor to determine how an issuer's financial reporting might go awry. The Panel found that, although auditors generally investigate issuers' internal controls, auditors do so with neither the necessary depth nor the requisite specificity of guidance from the ASB. The Panel therefore recommended that the ASB provide more specific guidance on the required depth of auditor knowledge and understanding about internal controls, as well as the nature and extent of testing of controls.[14] The Panel also recommended that audit firms "place a high priority on enhancing the overall effectiveness of auditors' work on internal controls, particularly with respect to the depth and substance of their knowledge about companies' information systems."[15] The Report noted a number of areas to be addressed by audit firms, including professional development and the increasing need for auditors to have a higher level of technology skills and far more effective participation in audits by information systems specialists.[16]

Risk Assessments and Designing Substantive Audit Tests

GAAS includes an audit risk model that requires auditors to use their judgment in assessing risks, selecting an audit approach, and deciding what tests to perform.[17] The model allows an auditor to take a variety of circumstances into account in selecting the audit approach for a particular engagement, including the auditor's understanding of the entity's business and industry and the entity's system of internal controls.[18]

For example, if an issuer's internal control over sales and accounts receivable is strong, the auditor might confirm only a limited number of accounts receivable at an interim date and rely in part on the company's internal controls and certain other tests for updating the accounts to year-end. Conversely, if a company's internal controls are not strong, the auditor might confirm a larger number of accounts receivable and do so at year-end.

The Panel believed that professional standards, guidance, and practices with respect to assessing inherent risk need to be strengthened given GAAS's increased emphasis on inherent risk assessments in determining the nature, timing, and extent of audit tests. In addition, because the assessment of inherent risk is such a crucial element of an audit, the Panel recommended that the engagement partner be involved in making the inherent risk assessment.[19] Finally, the Panel encouraged audit firms to review their policies and procedures with respect to linking the risk assessment to the actual nature, timing, and extent of tests performed during the audit.

Top Management of Accounting Firms Must Emphasize the Importance of Quality Audits, Including with Respect to Compensation and Advancement Decisions

The Panel found that messages from accounting firm management to audit personnel do not stress often enough the importance of quality audit work, either in terms of the work's importance to the firm or its role in protecting the interests of the investing public.[20] Indeed, the Panel's focus groups strongly indicated that the audit is commonly regarded by the audit firm personnel foremost as a commodity, and one of little value standing alone.[21] As a result, the Panel recommended that top management of accounting firms emphasize to all audit personnel the importance, both to the firm and to the public, of performing quality audits. According to the Panel, "[t]he message should be a positive, constructive message that is re-

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[13] Internal control is "a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations." SAS No. 78, cited at Report at 2.50. Controls that are relevant to an audit are those that pertain to or impact the entity's preparation of financial statements for external purposes.

[14] Report at 2.77.

[15] Report at 2.78.

[16] *Id.*

[17] In order to determine the depth of testing necessary for a particular item on an issuer's financial report, an auditor must first assess the risk that the item is misstated. For example, complex transactions are more easily misstated than simple ones; an auditor will, therefore, assess a complex transaction to be high risk and test that transaction more thoroughly than others.

[18] Report at 2.7.

[19] Report at 2.49.

[20] Report at 4.3.

[21] Report at 4.4.

freshed frequently so it commands attention, rather than becoming a tired slogan that is ignored."[22]

In addition, audit firms should ingrain "the importance of the role and responsibility of audit professionals, as well as the concepts of integrity and objectivity, independence, professional skepticism and accountability to the public" at the earliest stages of an employee's training.[23] Furthermore, throughout an employee's tenure, the performance of quality audits should be applauded and publicized, especially in situations where auditors take difficult stands on earnings management issues, issues involving possible fraud, or contentious accounting issues. In short, the Panel recommended a top-to-bottom reaffirmation within audit firms of their public duties as auditors.

Similarly, the Panel also recommended that audit firms "ensure that performing high quality audits is appropriately recognized as the highest priority in performance evaluations and in compensation, promotion, and retention decisions for all personnel."[24] The Panel recommended that performance and compensation measures should focus on such matters as: (1) the depth of understanding of the client's business, (2) responsiveness to unexpected conditions encountered in an audit, (3) professional skepticism and persistence, and (4) knowledge of accounting standards and principles.[25] By emphasizing quality audits in compensation and advancement decisions, the Panel reasoned, the quality of audits will inevitably increase.

Enhanced Communication with Audit Committees

There are several auditing standards that govern independent auditors' communications with audit committees. In general, the standards require that auditors inform audit committees about significant accounting policies and their application, management judgments and the process used in formulating particularly sensitive accounting estimates, significant audit adjustments, disagreements with management, consultation by management with other accountants, major issues discussed with management prior to being retained, and difficulties encountered in performing the audit.[26] In addition, two new standards regarding auditor's communications to audit committees were recently issued. The first requires auditors to communicate uncorrected misstatements, the effects of which management believes are immaterial. The second requires auditors to discuss their judgments about the quality, not just the acceptability, of the entity's accounting principles and the estimates underlying the financial statements.[27]

Notwithstanding these requirements, the Panel advocated that stronger relationships be established between auditors and the boards of directors and their audit committees that recognize that auditors are ultimately accountable to the board of directors and the audit committee as representatives of the shareholders.[28] The Panel further recommended the development of explicit mutual expectations of the board and audit committee, management, and the auditors as an essential first step in the process of developing a stronger relationship among these parties.[29] Finally, the Panel recommended that the auditor and company management advise the audit committee of the company's plans to hire any of the audit firm's personnel into high-level positions. On this last point, I personally believe the audit committee should be tasked with approving the hiring of any audit firm personnel above a certain level who worked on the company's audit.

Auditor Independence/Scope of Services

As the Panel's Report stated, "Independence is fundamental to the reliability of auditors' reports. Those reports would not be credible, and investors and creditors would have little confidence in them, if auditors were not independent in both fact and appearance."[30] The Panel noted that the effect of providing nonaudit services on auditor objectivity has long been an area of concern. We, therefore, focused specific attention on this issue. A full discussion of auditor independence is contained in Chapter 5 of the Panel's Report.

As an initial matter, let me state that the Panel fully supported the role of the Independence Standards Board (ISB), a body constituted by the joint effort of SEC and the accounting profession. The work of the ISB resulted in a clear definition

[22] Report at 4.5.
[23] *Id.*
[24] Report at 4.21.
[25] *Id.*
[26] Report at 2.205.
[27] Report at 2.205.
[28] Report at 2.216.
[29] *Id.*
[30] Report at 5.1.

of auditor independence, a comprehensive inventory of the potential threats to independence, and a listing of the ways such threats could be eliminated or satisfactorily mitigated. Most importantly, out of this work came a methodology for addressing independence issues based on a conceptual framework, not simply upon a set of wooden rules.

To the dismay of many in and out of the profession, the ISB was effectively terminated by the SEC's rulemaking initiative in 2000—the outcome of which was an essentially pragmatic, but incomplete resolution, which lacked a conceptual framework for addressing independence issues. I would very much like to see the restoration of ISB's conceptual framework and methodology so that emerging independence issues can be addressed and guidance developed promptly and consistently.

The SEC's November 2000 rule prohibits the provision of many nonaudit services to audit clients. However, two important services were not adequately addressed in the rule. These services constitute a significant part of the nonaudit services being performed by audit firms: (1) financial information systems design and implementation, and (2) internal audit outsourcing. Engagements to design and implement financial information systems often involve large numbers of professionals, last 2 to 3 years in duration, and generate substantial fees. Internal audit outsourcing refers to a company hiring its auditor for the purpose of conducting an internal audit.

All five major firms now have agreed to the proscription of such services to audit clients, and the AICPA also has supported that position with respect to public companies. The net result of the combined action of the SEC and the elimination of the two services I have described takes substantial amounts of the so-called "consulting" dollars off of the accounting firms' table and greatly reduces the magnitude of the nonaudit services issue.

In light of concerns that had been raised in prior years regarding the effects of these types of services on auditor independence, the Panel on Audit Effectiveness included in its review a study of engagements relating to issuers who received both audit and nonaudit related services from the auditing firm. And of the 126 public related audit engagements studied, the Panel identified 37 engagements in which services other than audit and tax had been provided.

As stated in the Report, the Panel's reviewers did not identify any instances in which providing nonaudit services had a negative effect on audit effectiveness.[31] To the contrary, the Panel found, "[O]n roughly a quarter of such engagements, the reviewers concluded that such services had a positive impact on the effectiveness of the audit." [32] The additional knowledge of the company's business and the skill sets enhanced by the performance of nonaudit services actually assisted the work of the audit team.

However, based on an independent survey and public hearings, we found that many people continue to be concerned "that the performance of nonaudit services could impair independence or that there is at least an appearance of the potential for impairment." [33]

Thus, the Panel did not reach unanimity with regard to a recommendation in this area. Rather, the Panel published a statement in support of an exclusionary ban on nonaudit services to audit clients, as well as a statement against such a ban.

The Panel did agree on the importance of the independence issue, and, therefore, made a number of recommendations in furtherance of the need for close monitoring of proposed nonaudit services. Among these recommendations, the Panel provided "guiding principles" to be considered by audit committees in contemplating whether to hire the company's auditor to provide certain nonaudit services.[34] According to the SEC's November 2000 rule on independence, the Panel's guiding principles "represent a thoughtful and appropriate approach to these issues by audit committees, and [the SEC] encourage[d] audit committees to consider the Panel's recommendations." [35]

It is my own opinion that the profession's decision to forego financial information systems design and implementation and internal audit outsourcing services to audit clients is correct. Despite the lack of evidence that these services, in fact, erode the independence of auditors, the evidence is strong that such services are perceived as

[31] Report at 5.18.
[32] *Id.*
[33] Report at 5.20.
[34] Report at 5.29. The Panel recommended that, in determining the appropriateness of a particular service, one guiding principle should be whether the service facilitates the performance of the audit, improves the client's financial reporting process, or is otherwise in the public interest. *Id.*
[35] 17 CFR 210, at 24.

a threat to independence. Furthermore, both services should typically be performed by the management of an issuer, not by its auditors.

With respect to other nonaudit services, I believe the conceptual framework that was under development by the ISB as the underlying rationale for independence standards—that the ISB would develop as necessary—would have provided a meaningful and proper way to distinguish which services should be allowed and which not. Whether the ISB's framework were to be applied by one of the audit profession's self-regulatory organizations or by a regulatory organization yet to be formed is less important than the need for some type of framework that will identify independence threats and provide guidance on appropriate safeguards in areas where acceptable practice is unclear or existing practice should be improved. Furthermore, it is my opinion that audit committees should take it upon themselves to review each nonaudit engagement with the company's auditor pursuant to the ISB's standards and the guiding principles set forth in the Panel's Report.

However, a rule banning all nonaudit services to audit clients would throw out the baby with the bath water, while failing to increase the level of auditor independence. Indeed, in light of the Panel's findings of the importance of an auditor's knowledge of the company and the importance of the auditor possessing related information technology skills, I believe banning all nonaudit services for audit clients could hinder audit effectiveness.

A Change in Governance of the Audit Profession

The accounting profession's combination of public oversight and voluntary self-regulation is extensive and overlapping, and yet in certain respects, insufficient to accomplish the goals of monitoring the activities of the profession, providing disciplinary action where appropriate, and establishing ethical standards and rules that will lead to enhanced public confidence in the profession. A veritable alphabet soup of organizations provides governance for the profession, a summary of which appears in Appendix C of the Panel's Report. Yet despite this extensive network of oversight (and, indeed, in part because of it), the Panel concluded that the profession's self-regulatory system suffers from certain limitations, some of which may be inherent in a voluntary system.[36]

Specifically, the Panel found that the current system of governance: (1) lacks sufficient public representation; (2) suffers from divergent views among its members on what should be the profession's priorities; (3) implements a disciplinary system that is slow and ineffective; (4) lacks efficient communication among its various entities and with the SEC; and (5) lacks unified leadership and oversight.[37]

In light of these significant shortcomings, the Panel recommended that there be a strengthened, unifying oversight body to help ensure the effective working of the governance system. In the Panel's opinion, the experience and the expertise of the independent POB would serve as a sound foundation for such an organization. We believed that, pursuant to a new charter, an expanded POB could aggressively oversee the profession's standard setting, monitoring, disciplinary, and special review functions. The POB would, therefore, serve as the oversight body to whom the SEC, the State boards of accountancy, the auditing profession, and the public would look for leadership.

Under the Panel's proposal, the POB would have the sole authority to determine the profession's financial obligations to the POB and the sole authority to determine its expenditures. The POB would also approve of the appointment of the chairs of various self-regulatory bodies (such as the ASB, which would continue to establish auditing standards) and approve all other appointments to such bodies; evaluate whether the funding of those bodies is sufficient for them to meet their mandates; and oversee the evaluation, compensation, hiring, and promotion of many of the entities' employees. The Panel also recommended the creation of a coordinating task force, composed of the chairs of each body within the POB's oversight, that would be responsible for sharing information related to each body's activities.[38]

Although membership of the POB already consists primarily of nonaccountants, the Panel recommended that members be term-limited and nominated by a committee comprised of members of public and of private institutions that are most concerned with the quality of audits and financial reporting. Members of these same constituencies would also comprise an advisory council to advise the POB on issues related to audit quality and financial reporting matters. And finally, the Panel recommended that the POB be given the authority to commission special reviews re-

[36] Report at 6.15.
[37] Report at 6.15.
[38] Report at 6.23–25.

lated to significant professional matters that affect the public's confidence in the audit profession.

I believe that a strengthened POB would have served the interests this Committee seeks to protect. Unfortunately, the POB has all but disbanded. There are, however, many similarities between the Panel's proposal and those being discussed by the SEC and the Congress. In theory, I am in favor of the creation of an organization to oversee the accounting profession, whether it is created by regulation or by legislation. If carefully structured to ensure effective oversight, disciplinary proceedings, and rulemaking in an unpoliticized environment, such an organization could serve the same purpose we had in mind for an expanded POB.

There are important considerations, however, in structuring a new entity to carry out these responsibilities:

First, it must be decided whether the new organization will assume an oversight role similar to that proposed by the Panel, or whether it will assume some or all of the responsibilities of existing self-regulatory bodies. With regard to the latter possibility, the Committee may wish to consider the following:

- One advantage in having Congress establish a new organization to assume the peer review, investigatory, and disciplinary functions of the profession is that Congress can provide statutory confidentiality protection for the materials, interviews, and findings developed as part of the organization's review and/or disciplinary processes. These processes in the past have been hampered by distrust and by concerns that the materials developed were not protected. Providing confidentiality will expedite and vastly improve the review, investigatory, and disciplinary processes.
- The ASB should remain the appropriate entity for establishing auditing standards, but I believe that an expanded POB—or if Congress determines, a new organization—should oversee the ASB's activities to the extent of appointing its chair and approving appointments of the remainder of the ASB and regularly evaluating its performance. This type of oversight could help assure that the ASB continually reexamines and timely addresses auditing issues that arise in the review and disciplinary activities conducted by the new oversight entity.
- The proposed new organization should not have the power to set, or even influence, the issuance of accounting standards. FASB today is beset with political pressure that directly hampers efficiency and, in some cases, the substance of the standard setting process. However, FASB, in my view, remains the right entity for determining accounting standards. The most important step Congress can take in improving accounting standards is to ensure that FASB is adequately funded and free from undue political influence.

Second, a new organization must remain independent from the profession, while remaining cognizant of current issues and trends affecting the profession. Congress or the principal regulator should determine an appropriate ratio of members from the profession versus public members. Moreover, the organization's funding should not be, in fact or appearance, reliant on the profession.

Third, the Congress should work hard to ensure that the oversight organization is sufficiently staffed and funded to carry out its sizable mandate. Already, the SEC struggles to keep up with its oversight responsibilities. If a new organization assumes the review responsibilities currently undertaken as part of the industry's peer review system, it will have to do the job that now is done by many hundreds of experienced employees, managers, and partners assigned by their firms to conduct peer reviews. It will be extremely difficult, if not impossible, as well as costly for a new organization to hire, train, and supply the hundreds of experienced staff that will be necessary to conduct reviews of the entire public audit profession.

Fourth and finally, I am aware of various efforts at the State level in the wake of Enron's collapse to provide greater substantive regulation of auditors. Congress should take steps to ensure that national accounting firms are subject to a clear and consistent set of regulations and do not find themselves guided by multiple, potentially conflicting, sets of rules. Such a system not only would be costly for accounting firms, but also it might actually create, rather than close, holes in audit oversight and could harm the efficiency of the capital markets.

Mandatory Rotation

Let me comment briefly on one recent proposal that I do not support.

There have been recent suggestions that audit effectiveness would improve by forcing issuers to change auditors every few years. I believe such a requirement would undermine audit effectiveness. The findings of the Panel reinforced the commonly-held understanding that audit effectiveness increases proportionately with an auditor's familiarity with an issuer's business, its inherent risk factors, and its

internal controls. In light of the growing complexity of today's business operations—in terms of technology, business processes, financial control procedures, and globalization—such knowledge, accumulated over time by members of the audit team, is critical to effective auditing.

The empirical evidence supports this notion. A study conducted by the AICPA into over 400 cases of alleged audit failure between 1979 and 1991 indicated that the alleged failures occurred almost three times as often when the auditor was performing his first or his second audit of the company. And similarly, the 1987 Treadway Commission's review of fraud-related cases revealed that a "significant number involved companies that had recently changed their independent public accountants. . . ."

I know there have been a number of failures, as well, where the company's auditors had been on the scene for many years. But logic simply tells you—and the recommendations of our Panel support this—that knowledge of and experience with the audit client's business, internal controls, and culture form the basis for an effective audit. I firmly believe that mandatory rotation would introduce inefficiencies and greater costs and, in the end, would diminish, rather than enhance, audit quality.

Conclusion

Our capital markets are not broken. They may have been bent, but they are wonderfully resilient and have stood the test of time. I believe that much can and should be done by the accounting profession itself to improve audit effectiveness. I also believe that much can and should be done by other professionals and entities that comprise the safety nets that combine to build confidence in our capital markets and protect the investing public. And I believe that the Congress certainly can play a constructive role in holding the type of hearings that have been undertaken by this Committee and, if necessary when all of the facts are gathered, by crafting legislation in the public interest. I do want to urge caution in whatever legislative proposals are advanced, because I fear that a hastily crafted package could potentially harm, rather than help, the cause of audit reform.

I appreciate the opportunity to give you my views, and, going forward, I will be pleased to assist this committee in whatever manner would be most helpful.

PREPARED STATEMENT OF LEE J. SEIDLER

DEPUTY CHAIRMAN OF THE 1978 AICPA
COMMISSION ON AUDITORS' RESPONSIBILITIES
MANAGING DIRECTOR EMERITUS, BEAR STEARNS

MARCH 6, 2002

Mr. Chairman, I thank you for your invitation to participate in these hearings. I served as the Deputy Chairman of the Commission on Auditors' Responsibilities, in charge of the day-to-day operations of the Commission and its staff and, with Douglas Carmichael was the principal writer and editor of the Commission's Report. And this group was more commonly known as "The Cohen Commission" after its Chairman Manuel F. Cohen. "Manny" unfortunately died in June 1977, shortly after the Commission[1] issued its *Report of Tentative Conclusions.* Thus, the largely unchanged final *Report, Conclusions, and Recommendations* of the Cohen Commission reflects the former SEC Chairman's lifelong commitment to the public interest and to improving the functioning of American securities markets.

The Commission was appointed by the American Institute of Certified Public Accountants (AICPA) to:

> Develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. It should consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved.[2]

The seven-member Commission was drawn from the accounting profession, industry, financial services and academe. It met monthly for 66 meeting days between 1974 and 1978. The Commission conducted 26 separate research projects and sur-

[1] To avoid confusion in this testimony, I will refer to the Commission on Auditors' Responsibilities as the "Commission" or the "Cohen Commission" and to the Securities and Exchange Commission as the "SEC."

[2] Report, Conclusions, and Recommendations at xi. Hereinafter "Report."

veys and held a variety of conferences and interviews with members of Government, the accounting and the legal professions in the United States and Canada, stock exchanges and others. After the Report of Tentative Conclusions was issued, the members of the Commission and the staff participated in seminars and made presentations of the Commission's positions to more than 60 meetings of professional and business organizations. The AICPA and the State societies of CPA's conducted 123 member forums.

The final *Report, Conclusion, and Recommendations,* 195 pages and approximately 100,000 words, was fully and unanimously agreed to by all the members of the Commission. That there were no dissents was due to the cordial working relationship between the members, the excellent work of the highly qualified, conscientious staff and to Manny Cohen's belief that to be effective we had to be unanimous. We were unanimous, but not necessarily effective. Most of our important recommendations were never acted upon.

Although at times the administration of the AICPA disagreed with many of the conclusions that the Commission was reaching, the Commission received all the resources and the full cooperation it required from the AICPA.

Conclusions: The Expectation Gap Exists

The fundamental conclusion of the Commission was summarized as:

> The charge suggests the possibility that a gap exists between the performance of auditors and the expectations of the users of financial statements. . . . The Commission concludes that such a gap does exist. However, principal responsibility does not appear to lie with the users of financial statements.
>
> In general, users appear to have reasonable expectations of the abilities of auditors and of the assurances they can give.
>
> The burden of narrowing the gap . . . falls primarily on auditors and other parties.[3]

If a "gap" existed in 1978, it is a chasm in 2001. In a comment that sadly foreshadowed the current furor generated by disclosures about Enron, the Commission noted:

> The public accounting profession has failed to react and evolve rapidly enough to keep pace with the speed of change in the American business environment.[4]

As might be expected, until preparing for this testimony I have not reread the Commission's Report for many years. I am pleased to say that in most respects the analyses, conclusions, and recommendations in the Report remain valid. I believe that had some of our most critical recommendations been adopted, many of today's issues would not have arisen.

In the following testimony, I will emphasize those recommendations of the Commission, *still not adopted by authoritative bodies,* that would help close today's chasm and speed the evolution of the accounting profession. In addition, I will present several of my own recommendations in areas that were addressed by the Commission, but which today appear to require stronger medicine than was prescribed by the Commission in 1978. The passage of a quarter century (and the difficulty of finding them) has prevented me from reviewing these recommendations with other Commission members. While here I speak only for myself, I believe that my fellow Commission members would agree that changed conditions, the increased complexity of business transactions and the deterioration of many aspects of the accounting profession warrant these more stringent measures.

I hope the actions proposed here will receive early consideration by the Committee. The impacts of Enron, in isolation, while costly to Enron shareholders and devastating to employees' retirement plans, would have had no significant effects on markets or the economy. However, the realization that some other companies use the accounting techniques employed by Enron has already had a short-term impact on market volatility. The validity of the financial reporting of many companies, supposedly in accord with Generally Accepted Accounting Principles (GAAP) and audited by independent accountants, is daily questioned by investors and analysts.

In the 1970's, I was the first brokerage analyst to make a specialty of dissecting and challenging the financial reporting of public companies. The then lax accounting rules in franchising, leasing and revenue recognition provided me with easy targets. Many others later followed me into that specialty. I suspect that Enron heralds a

[3] Report at xii.
[4] Report at xii.

revival of "accounting analysis." There is nothing inappropriate about such scrutiny, indeed, it increases market efficiency. However, unless investors perceive that effective action is being taken to remedy these apparently widespread deficiencies and to reduce the frequency of accounting surprises, confidence in the existence of a "fair game" in the market may suffer.

Outline of Proposed Actions

In the following testimony I will suggest a series of actions to be taken which can be implemented through legislation or regulation. With the exception of those directly related to the proposed statutory self-regulatory organization (SRO) and the audit requirement for quarterly reports, they could also be implemented by existing private organizations: The Auditing Standards Board of the AICPA, the FASB, or the Public Oversight Board.

Increase the Budget of the SEC

However, allow me to first present a call to this Committee. The Securities and Exchange Commission, SEC, has been a critical and effective force for improvement in financial reporting and in the overall functioning of American capital markets. Notwithstanding impression created by the Enron debacle, the United States has the best and most comprehensive financial reporting in the world. Much, perhaps most, of the credit for our system must go to the effective work of the SEC. The proposals I am making will add even more to its responsibilities. The SEC's budget is miniscule, compared to the rest of the Federal budget and, more important, to the values in the capital markets it oversees. I urge the Committee to take action to significantly increase the SEC's budget to allow it to continue to protect our capital markets.

My proposals are:

- Enact legislation establishing a statutory self-regulatory organization (SRO) with the NASD as a model and, under the direction of the SEC, responsible for financial reporting standards and regulation.
- Move the AICPA's standard setting and regulatory operations out of the Institute and into the new SRO.
- Make the Financial Accounting Standards Board an integral element of the Financial Reporting SRO.
- Replace the present peer reviews of accounting firms by accounting firms with examiners from the SRO staff.
- To reduce the potential corrupting influence of consulting fees, prohibit the performance of nontraditional consulting for audit clients of public companies.[5]
- Require Forms 10–Q and published interim financial statements to be audited as part of a continuing audit process.
- Require audit committee approval to hire former auditors.
- Require auditors to evaluate the financial statements as a whole.
- Require "preferable" rather than "acceptable" to be the standard in the selection and application of accounting principles.
- Require companies to record *all* clearly correct adjusting entries proposed by auditors, regardless of materiality.

The Commission also addressed significant deficiencies in the education and professional preparation of independent auditors. In retrospect, these recommendations, still not implemented, were among the most important made by the Commission for, as discussed below, in the quarter century since they were made the accounting profession has lost a great part of its professionalism. The recommendations are:

- Establish graduate professional schools of accounting.
- Reduce the schism between academic and practicing accountants.

A Model for Self-Regulation of Financial Reporting

The Cohen Commission studied then current efforts by individual firms and by professional organizations to establish quality control policies and procedures to encourage compliance with professional standards. It concluded:

> The Commission believes that the oversight of professional practice should remain within the profession and that the concept of individual firms' having responsibility for the quality of their own practice should be retained.[6]

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[5] For brevity the term "public companies" is used to denote those entities whose securities are publicly-traded.

[6] Report at 145.

The Commission recommended a number of further steps, including peer review. The recommendation for public presentation of peer review results in a "long form" report has been mostly adopted.[7] Reports of peer reviews and the related letters of comment are now available on the Internet but they provide little specific detail. For example, when deficiencies are noted, the letters do not indicate which offices were involved.

The Commission's recommendation that disciplinary action not be postponed until all litigation was ended[8] has been implemented to a limited extent. The Quality Control Inquiry Committee (QCIC) of the SEC's Practice Section of the AICPA (SECPS) now investigates substandard audits quickly but the results are reported only to the Public Oversight Board (POB) and the SEC; they are not made public. And of the Commission's most important recommendations, only those asking for greater auditor concern with detecting fraud have been adopted, albeit gradually.

The Commission also studied the sanctions that could and were being imposed on individuals and firms for performance or conduct that violated professional standards. It is not unfair to say that the Commission was disappointed by the then current situation (which does not appear to have changed significantly). It noted:

> *Failure to Address Significant Problems.* With a few exceptions, individuals appear to be penalized only for infractions which involve advertising (no longer forbidden) or client solicitation and felony convictions related to the preparation of false tax returns. While not unimportant, those are not major problems facing the profession today. The major problem is substandard performance.[9]

However, after suggesting a number of areas for improvement it was concluded, unfortunately incorrectly, that more progress would be made. With this optimistic outlook, the Commission noted:

> An organization could be established within the profession that would have the ability to penalize firms for substandard performance. Such organizations do exist in other areas, for example, the National Association of Securities Dealers. . . . We do not see any promise that the creation of a regulatory body as described above would be a significant improvement on the present mixture of private and public regulation.[10]

I now believe that this conclusion, with which I agreed earlier, was wrong. Substandard performance does not appear to have been reduced or curtailed. Indeed, some recent cases are in many respects more egregious than any reviewed by the Cohen Commission.[11] I do not like to rely excessively on evidence from one case, but the actions of a major firm, as disclosed in the recent SEC release on Arthur Andersen and Waste Management, strongly suggest that the problems are deeper than any of those contemplated by the Cohen Commission.

The following excerpt from an SEC release on Arthur Andersen and Waste Management summarizes the essence of that case.

> As alleged in the Commission's complaint or found in its related administrative order: In each of the years 1992 through 1996, the Andersen engagement team identified a variety of improper accounting practices that caused Waste Management's operating and income tax expenses to be understated and its net income to be overstated. While Andersen quantified some of these misstatements, other known and likely misstatements were not quantified and estimated, as required by GAAS. In connection with the audit of Waste Management's 1993 financial statements, Andersen proposed a series of "Action Steps" to change the company's improper accounting practices only in future periods and to write off its prior misstatements over a 5 to 7 year period, rather than require immediate correction in accordance with GAAP. Andersen also allowed Waste Management to, in Andersen's own words, "bury" certain charges by improperly netting them against unrelated, one-time gains. Andersen told Waste Management that its use of

[7] Report at 146.
[8] Report at 150.
[9] Report at 179.
[10] Report at 181.
[11] It is important to note that we do not know the actual extent of substandard performance. Specific instances of substandard performance are disclosed only when revealed by some other event such as a restatement or bankruptcy. Most substandard audit performance, to the extent that it exists, probably will never be disclosed. I would like to believe that the vast majority of audits are completed conscientiously in accordance with the standards. However, in an ominous note, the Commission's research revealed that a majority of auditors had, at one time or another, signed off for audit work that they did not actually perform. (See Report at 179).

> netting was an "area of SEC exposure" but nonetheless allowed it to occur. Ultimately, when the misstatements were revealed, Waste Management announced the largest restatement in American corporate history. In issuing an unqualified audit report on the restated financial statements, Andersen acknowledged that the financial statements it had originally audited were materially misstated.[12]

The facts of this case are unique, not only in their magnitude, but in the actual accounting proposed. The notion that misstatements could be written off over some future period, rather than immediately corrected, is unsupported, indeed unheard of, anywhere in accounting practice or literature.

Worse yet was the consultation process and the concurrence of those consulted:

> For example, in its 1993 audit, Andersen quantified current and prior-period misstatements of $128 million, the correction of which would have reduced net income before special items by 12 percent. The engagement team also identified, but did not quantify or estimate, accounting practices that gave rise to other known and likely misstatements. Allgyer *(the engagement partner)* and Maier *(then the risk management partner for Andersen's Chicago office and the concurring partner on the Waste Management engagement)* consulted with the Practice Director and the Audit Division Head and informed them of the quantified misstatements and "continuing audit issues," and Allgyer consulted with the Firm's Managing Partner and they provided him the same information. The partners determined that the misstatements were not material and that Andersen could issue an unqualified audit report on the Company's 1993 financial statements.[13]

Thus, this is not the case of an ignorant or "renegade" partner. Instead, this bizarre accounting was approved by a series of reviewers, all the way to the highest level in the firm.

The Cohen Commission did not find any case exhibiting such pervasive concurrence with such bad accounting. And as I said earlier, most of the significant recommendations of the Cohen Commission, made 24 years ago, for reducing substandard performance have not been adopted by the present private financial reporting establishment. I do not know if my other Commission members would concur, but I now believe that a stronger, statutorily directed oversight structure is called for if necessary improvements are to be made.

The NASD Model

A number of proposals for more stringent oversight of the accounting profession have been made in recent weeks, including that of the Chairman of the SEC and in legislation introduced in the House of Representatives.

Both call for new organizations. I have learned that it is usually more efficient to look to and copy existing, successful models rather than invent new devices. And I believe:

- The NASD provides a model for a statutory self-regulatory organization (SRO) that could be applied to the accounting profession.
- Enacting legislation to transfer the AICPA's standard setting operations and the oversight responsibilities to the new self-regulatory organization for financial reporting would be the quickest and most efficient way of commencing operations of the SRO.

I make this call for increased regulation of my profession with no small regret. I am a CPA, my father was a CPA. I started my career as an auditor. Such success as I have achieved is heavily due to what I learned as an accountant. I was privileged to work for or with some truly proud professionals and truly independent accountants such as Paul Grady, Philip Defliese, Joseph Cummings, Ray Groves, Robert Hampton and on the Cohen Commission, LeRoy Layton and Kenneth Stringer.

I believe all of them would be truly outraged at many aspects of their profession today. Their firms, once managed by the leading technicians and theoreticians in the profession are now frequently led by "rainmakers" selected for their ability to generate new business, not for their accounting knowledge. Too many firms and practitioners in a profession dedicated to the public interest have become too dedicated to private gain.

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[12] Securities Exchange Act of 1934, Release No. 44444 / June 19, 2001. This writer was engaged by the SEC to serve as an expert witness in this matter. However, comments included here are based solely on the published releases by the SEC.

[13] Securities Exchange Act of 1934, Release No. 44444 / June 19, 2001.

I make these comments not because of the Enron case. The gradual deterioration of the professional conscience of at least a sizable minority of public accountants has been continuing for the past several decades. Enron is merely a widely publicized symptom that may at least have the benefit of bringing about long delayed changes in the accounting profession. Ultimately, these changes must come not through regulation but by restoring the sense of professionalism that too many accountants seem to have lost. These are changes that Congress cannot enact, the SEC cannot promulgate. The management of accounting firms must be returned to accountants, not salesmen. Accountants must be educated as professionals in the same manner as the lawyers, doctors, and members of the other liberal professions.

The NASD

I assume there is no need to recount the history and functions of the National Association of Securities Dealers (NASD) for the Members of the Committee, but I will give a very brief summary for other readers.

The precursor of the NASD was the Code Committee formed by the investment banking business under the National Recovery Act (NRA) in 1933. When the NRA was declared unconstitutional, the members voted to continue the organization on a voluntary basis. That private voluntary organization grew and changed its name to the Investment Bankers Conference. In 1937, the governing committee of the Conference, working with the SEC, drafted legislation to create it as a self-regulatory organization. The legislation that came to be know as the Maloney Act was signed by President Roosevelt on June 25, 1938. In 1939, the organization was renamed the National Association of Securities Dealers.

The relationship of the NASD and its subsidiaries to securities markets and to its participants is, in many ways, comparable to the functions of the AICPA and the Financial Accounting Standards Board (FASB), including development of qualifying examinations, registration of sales and supervisory personnel, regulation of individual ethics and business conduct, education and publications, and establishing rules of fair practice. Of course, it also has other operations, not comparable to the AICPA, such as the Nasdaq market and overseeing the American Stock Exchange.

Create A National Financial Reporting Oversight Board

There have been several proposals to create a new oversight body, some aimed at replacing or expanding the Public Oversight Board of the AICPA. With the evolutionary NASD model in mind, I see no reason to invest the enormous effort that would be involved in creating an entirely new organization.

The AICPA's SEC Practice Section (SECPS), Auditing Standards Board (ASB), Accounting Standards Executive Committee (AcSEC) and Professional Ethics Division are already staffed and operational. The time and money saved by starting with these existing units of the AICPA, which appear to comprise about 30 percent of the Institute's total expenses, would be significant. The SEC's familiarity with these AICPA groups would conserve the SEC's scarce resources.

I propose that legislation be developed through joint efforts of the AICPA, State CPA societies and boards, other accounting professional organizations and the SEC and enacted in the same manner as the Maloney Act to create a new National Financial Reporting Board (NFRB) based on a core of the appropriate elements of the AICPA.[14] Statutory direction would, hopefully, accelerate the past and the current torturously slow rate of improvement in the accounting profession.

The NFRB would fit into and amplify the present structure of professional regulation. CPA's are licensed by State boards of accountancy which system would be undisturbed. Note that individual securities brokers must be licensed by the States in which they deal. The NFRB could license or otherwise qualify *firms* that audit public corporations in much the same manner that broker-dealers are regulated under SEC Regulation M and by NASD Regulation, Inc. (NASDR, a subsidiary of NASD). The present Public Oversight Board (POB) and the SEC Practice Section of the AICPA would be the basis for an arm comparable to NASDR in the area of regulation of firms auditing public companies. The Quality Control Inquiry Committee (QCIC) of the SECPS already investigates substandard audits and likely would to do so, but having subpoena power and making its findings public. Financing of the NFRB would logically come from direct charges to public companies and accounting firms qualifying to audit public companies.

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[14] I have no pride of authorship related to the title National Financial Reporting Board (NFRB). Another descriptive title, hopefully with a more pronounceable acronym would be acceptable.

Preserve State Societies and Regional Firms

State societies and State boards of accountancy play a major role in licensing and maintenance of professional standards. For example, the New York State Society of Certified Public Accountants (NYSSCPA) is active at all levels of professional development. Its magazine, *The CPA Journal,* is one of the few forums available for the publication of debates and critical comment on issues in financial reporting by practitioners and educators. It is far superior intellectually to *The Journal of Accountancy* published by the AICPA. State societies are in some ways competitive with the AICPA—they have significant unduplicated memberships—and their continued contribution to professional development must be preserved.

There are high quality local and regional accounting firms, some of which specialize in specific industries and whose practice includes auditing some public companies. Care must be taken to assure that the NFRB makes appropriate allowance for services rendered by CPA's who are not principally occupied with audits of public companies and for the private companies they audit. This care should *not* include different auditing standards, but would address, for example, different requirements for advice and consulting that private companies require from their accountants.

Hopefully the creation of an NFRB that I am proposing will have the same effect as that suggested by Senator Francis T. Maloney, sponsor of the 1938 Maloney Act Amendment to the Securities Exchange Act of 1934:

> This Act is designed to effectuate a system of regulation . . . in which the members of the industry will themselves exercise as large a measure of authority as their natural genius will permit.

Merge the FASB into the NFRB

When the Financial Accounting Standards Board (FASB) was created, essentially by carving the accounting standards setting function out of the AICPA, I wrote an article titled "Goldfish in a Bowl of Sharks." [15] I predicted that the new FASB (the goldfish), no longer enjoying the built in support and shield of the accounting profession and the large accounting firms and the membership of the AICPA, would be highly vulnerable to influence and pressures exerted by all the other parties (the sharks) affected by financial reporting. The AICPA, I suggested, having lost its most important professional function—standard setting—would be reduced greatly in professional status.

Unfortunately, these forecasts were mostly accurate. The FASB has been beset by enormous outside pressures. Returning to being part of the principal accounting professional organization will give it the strong support of the NFRB and a shield against attempts to unduly influence its decisions. In addition, the FASB, alone in bucolic Connecticut, has been somewhat isolated from the mainstream. Integration into the National Financial Reporting Board will provide better direction and focus for the FASB's efforts. With the AICPA's Auditing Standards Board and Accounting Standards Executive Committee also under its umbrella, the NFRB would have the standards setting responsibility for the accounting profession, as well as responsibility for overseeing the appropriate application of those standards, under the ultimate direction of the SEC.

I might add that I have heard proposals that the directorship or board of an SRO created in this situation be "independent" of the accounting profession. That is, the membership would not include professional accountants. I disagree strongly with that notion. It is the equivalent of suggesting that the board of directors of a corporation exclude any member with extensive experience in the corporation's industry. To the contrary, the board of the SRO should include a reasonable number of members with strong public accounting backgrounds. Despite the decline in certain aspects of the accounting profession, there are still many highly qualified, independent accountants who can bring leadership talents to a financial reporting SRO.

The FASB is principally funded by contributions from public accounting firms and public companies, as well as revenues generated by its publications. As part of the NFRB, its financing would come through the NFRB.

Professional Auditors of Auditing Firms

At present, the Public Oversight Board's (POB) peer reviews of members of the SECPS are performed by their "peers," that is, other accounting firms. Major accounting firms are reviewed by other major accounting firms. Despite a series of SEC cases and private litigation which revealed clearly substandard auditing work, no major firm appears to have been publicly sanctioned as a result of a peer review.

[15] *The Accountants Magazine* (Scotland) 1973.

While the major accounting firms are willing to "peer review" each other where the results of specific audits are not disclosed, they are not willing to testify against each other in open court. When the SEC brings charges against a firm of public accountants, other accounting firms will not serve as expert witnesses for the SEC, despite the fact that several firms have sections devoted to litigation support. Most financial accounting professors at universities, apparently unwilling to risk the wrath of the accounting firms who often support their work, also are unwilling to testify against accounting firms.

This situation suggests that when the NFRB is established, it should develop its own auditors to examine public accounting firms and not depend on review by peers.

The Influence of the Fees on Auditor Independence

The relationship between independent auditor and client is unique in our society. In theory, the auditor works for and protects the shareholders. In practice, the management of the corporation pays the independent auditor to assure that management's financial reporting is accurate. A doctor cures his patients, a lawyer represents his clients but an independent auditor polices the management that pays him.

For this unique relationship to work, the auditor must be truly independent, willing to tell the client what is wrong, to insist that what is wrong be corrected or to walk away from the client . . . and from a stream of future fees. The drafters of the Securities Laws understood the value to the capital markets of this independent control over the accuracy of financial statements. By requiring that all companies whose securities were publicly-traded have financial statements audited by independent accountants they virtually guaranteed a market for the services of American CPA's. The accounting profession, particularly the larger firms, grew and prospered under this mandate.

Now, recent cases and the comments of many critics strongly suggest that this critical independence is being subverted by fear of losing the client and future fees. The following excerpt from the SEC's release on Arthur Andersen and Waste Management[16] provides interesting insight into some of the ways in which an auditor's independence was compromised:

- As noted in the order as to Andersen, this conduct took place against the following background:
  - Andersen has served as Waste Management's auditors since before Waste Management became a public company in 1971.
  - Andersen regarded Waste Management as a "crown jewel" client.
  - Until 1997, every chief financial officer ("CFO") and chief accounting officer ("CAO") in Waste Management's history as a public company had previously worked as an auditor at Andersen.
  - During the 1990's, approximately 14 former Andersen employees worked for Waste Management, most often in key financial and accounting positions.
  - Andersen regarded Allgyer as one of its top "client service" partners. Andersen selected Allgyer to become the Waste Management engagement partner because, among other things, Allgyer had demonstrated a "devotion to client service" and had a "personal style that . . . fit well with the Waste Management officers." During this time (and continuing throughout his tenure as engagement partner for Waste Management), Allgyer held the title of "Partner in Charge of Client Service" for Andersen's Chicago office and served as "Marketing Director." In this position, Allgyer coordinated the marketing efforts of Andersen's entire Chicago office including, among other things, cross-selling nonattest services to audit clients.
  - Shortly after Allgyer's appointment as engagement partner, Waste Management capped Andersen's corporate audit fees at the prior year's level but allowed the Firm to earn additional fees for "special work."
  - As reported to the audit committee, between 1991 and 1997, Andersen billed Waste Management corporate headquarters approximately $7.5 million in audit fees. Over this 7 year period, while Andersen's corporate audit fees remained capped, Andersen also billed Waste Management corporate headquarters $11.8 million in other fees.
  - A related entity, Andersen Consulting, also billed Waste Management corporate headquarters approximately $6 million in additional nonaudit fees. Of the $6 million in Andersen Consulting fees, $3.7 million related to a Strategic Review that analyzed the overall business structure of the Company and ultimately made recommendations on implementing a new operating model designed to

[16] Securities Exchange Act of 1934, Release No. 44444 / June 19, 2001. This writer was engaged by the SEC to serve as an expert witness in this matter. However, comments included here are based solely on the published releases by the SEC.

"increase shareholder value." Allgyer was a member of the Steering Committee that oversaw the Strategic Review, and Andersen Consulting billed his time for these services to the Company.

- In setting Allgyer's compensation, Andersen took into account, among other things, the Firm's billings to the Company for audit and nonaudit services.

This excerpt needs little elaboration. Allgyer is described as a marketing man, cross-selling other Andersen services. The audit fee was capped but other fees were not. Thus, if Allgyer were to take a strong stand against the client he would have risked losing not only future audit fees, but also the even larger consulting fees. In addition, one might also ask how objective Allgyer would be in auditing the results of actions taken in accord with his own strategic review.

Given the strong pressures that fees of any sort exert on maintaining independence, it seems logical to eliminate, when possible, fees that bear no relation to the audit function.

Prohibit the Performance of Certain Management Consulting for Audit Clients of Public Companies

The Cohen Commission examined the question of whether performing management consulting impaired the independence of auditors. The Commission staff searched for cases where impairment of independence resulted from management consulting engagements. The Commission also solicited leading critics of the profession for specific cases. With the possible exception of Westec, no cases were found. The Commission analyzed the problems potentially associated with each of the nonaudit services then performed by independent auditors. Its conclusion:

> No prohibition of management services is warranted.[17]

However, this conclusion, reached in 1978, should be viewed in the light of another comment in the Commission's report:

> Auditing dominates the practice of large public accounting firms, but it has never been the sole function performed by public accountants.[18]

However, the business volume relationship between auditing and management consulting has changed since then. Twenty-two years later, the Panel on Audit Effectiveness (PAE) of the Public Oversight Board presented the following figures for the "Big 5" accounting firms in 1999:

Percent of Revenues

	All Clients	SEC Clients
Auditing	34 percent	48 percent
Consulting	44 percent	32 percent

The growth in the last decade of the 20th Century was particularly rapid. The PAE reported that the ratio of auditing revenues to consulting revenues from SEC clients went from 6:1 in 1990 to 1.5:1 in 1999.[19]

The Cohen Commission did recommend a series of safeguards to reduce the chance that independence would be impaired: Increased director and audit committee involvement and public disclosure of other services. These recommendations have been accepted in one form or another.

The PAE examined the same issue of whether the performance of certain management services should be prohibited. The PAE members divided, with some members for exclusion of certain management services and others for no exclusion. The Panel therefore made no recommendation.

It's the Fees, Stupid

In arriving at their conclusions, both the Commission and the PAE took the same approach; search for examples where the performance of management services impaired the appropriate performance of the audit. That is, find instances where, because the auditor's consulting arm had provided services the auditor was compromised in examining or auditing the results of those services. Neither found any examples. In effect, the theory was not supported by empirical evidence. The PAE pointed out the difficulty of actually finding any such "smoking gun."

[17] Report at 102.
[18] Report at 95.
[19] Panel on Audit Effectiveness at 5.13.

I would suggest a different framework for viewing the issue: The impact of consulting *fees,* not consulting *work,* on the independence of the auditor. As discussed above, an auditor taking a strong stand against a client risks losing a future stream of audit fees from that client. Consider the excerpt above from the Andersen and Waste Management case. A truly independent audit partner would have faced losing a stream of consulting and other fees even greater than the audit fee.

In addition, the audit partner, Allgyer, essentially was the salesman for the consulting services and was compensated for selling them. Recall the comment above that Allgyer had a "personal style that . . . fit well with the Waste Management officers." Would the style of a strong independent auditor have fit as well?

The Panel on Audit Effectiveness noted in its surveys that working auditors received the message that quality audit work was not important, that the audit has little value and that other services were more important.[20] Some audit firm partners to whom I have spoken believe that audits are often offered as "loss leaders," in other words, *as entry for sales of consulting services.* In my capacity as an Audit Committee Chairman soliciting proposals for new independent auditors I witnessed substantial price competition and the submission of bids that were clearly well below normal billing rates. Virtually every audit partner tries, at one time or another, to sell consulting services to audit clients.

I hold an economics degree and am not about to condemn price competition. However, in the auditing context, absent a high level of professional integrity and supervision, it can result in substandard work. For example, the Cohen Commission's extensive survey of working auditors found that fully 58 percent admitted to having signed off on a required audit step, not covered by another audit step, without completing the work or noting the omission of the procedures. "Time budget pressure," the result of low fees, was by far the most common reason cited.[21]

A second impact of "loss leader" pricing is a potential loss of independence. Professional ethics forbid an auditor to undertake an examination if the client has an unpaid balance from a prior audit. This is logical, since the debt may give the auditor a pecuniary interest in assuring the continuing business of the client. If an auditor has priced an audit so low that it will take 2 or 3 years for the original loss to be recovered—a period cited to me by several audit partners—is that not the same position as being unpaid for a prior examination?

While one would not want to interfere with price competition, some steps can be taken to alleviate the problems described just above. First, the NFRB should extend the rule against commencing a subsequent audit when a prior year's fees remain unpaid to also apply when the prior year's *costs* are unrecovered.

Audit committees generally now have the responsibility for engaging the independent auditor. Well before the current requirements for the audit committees of public companies were instituted, the Cohen Commission recommended that audit committees carefully consider the tradeoffs between price and quality in audit proposals.[22] In doing so, audit committees should emphasize the quality and capability of different firms before considering price. When negotiating fees, audit committees, interested in assuring that they are receiving truly independent audits, should eschew arrangements that will tend to compromise independence, such as fixed fees for a period of years.

Which Consulting Services to Permit? Which to Prohibit?

This testimony is not the place to provide a detailed answer to these questions. However, some general concepts may be developed here which could be amplified by NFRB, SEC, or legislative action.

First, we are considering only auditors of public companies with shareholders or creditors removed from direct contact with or control over management. The owners and creditors of private businesses are capable of making their own decisions as to what consulting is appropriate.

Second, audit partners frequently are highly knowledgeable about the business and industries they audit. They should be encouraged to give management and the board of directors the full benefit of that knowledge as advice and counsel. For example, it may be decided to forbid management consultants associated with accounting firms to take M&A engagements similar to those undertaken by investment bankers, but nothing should prevent an audit partner from giving a board of directors advice about a proposed merger or acquisition.

[20] Panel on Audit Effectiveness at 4.3 and 4.4.
[21] Report at 179–180.
[22] Report at 107. Most public companies are required to follow the standards set in the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.

In short, those services that an audit partner (or senior audit staff) can render *themselves* should not be prohibited. The Panel on Audit Effectiveness, noting the increasing complexity of business systems and the need for specialized knowledge to audit them, listed a series of "audit support" consulting services.[23] Such services should be permitted.

There are "traditional" nonauditing services offered by accountants; the most significant of which is providing tax advice, planning and return preparation. There is no logical reason to forbid such services which have been offered without problems for decades. However, the structuring, by accounting firms often employing lawyers, of sophisticated, complex, sometimes marginally legal tax shelters (for high fees) recently has become an issue. This would be the type of "nontraditional" consulting, along with strategic planning, business reengineering, investment banking, executive placement, legal and actuarial services, that will warrant consideration as being prohibited for firms performing independent audits of public companies.

Require Forms 10–Q and Interim Financial Statements to be Audited as Part of a Continuing Audit Process

The Commission recommended:

> The audit should be considered a "function" to be performed during a period of time, rather than an audit of a particular set of financial statements. The annual financial statements should be only one, although the most important, of the elements audited. Eventually, the audit function should expand to include all important elements of the financial reporting process.[24]

This call for a change in the nature of the audit was considered radical at the time. Although proposed again by Robert Elliott, a recent Chairman of the AICPA, the concept has not been embraced by the profession. However, in discussions following the Enron disclosures, there have been repeated calls for release of more current financial information.

It will take time to develop standards for auditor association with "current" financial information. However, a first and significant step would be to require, by statute or regulation, that quarterly reports of public companies be "audited." Such reports are currently "reviewed" on a timely basis under procedures set forth in SAS No. 71 (1992). It should not be difficult to modify SAS No. 71 to integrate the procedures called for therein with the annual audit, as envisioned by the Commission.

It will take a greater, but by no means an insurmountable effort, to develop a framework for the "audit function" envisioned by the Commission. With such a structure in place, rapid progress could be made to provide forms of assurance on more financial information that may be more current than quarterly reports.

Former Auditors Working for Clients: Notify the Audit Committee

The previously cited SEC release on Arthur Andersen and Waste Management noted that a significant number of former Andersen auditors occupied high level financial positions in Waste Management. The same appears to have been true in Enron. This migration from auditor to financial management is neither new nor unusual. The accounting profession has traditionally been a source of talent for companies, with individuals often moving to the same companies they audited.

There are positive aspects to this flow. The company hires people already familiar with operations. If the auditor retains the professional sense of being a CPA, as well as being a corporate manager such employment is likely to be a positive force for integrity of the company's financial reporting.

There are also negatives. In the worst case, the former auditor knows exactly how his or her former firm conducts the audit, and how to conceal information from them. In a less ominous sense, the former auditor knows how far former compatriots can be pushed to accept results preferred by management. In general, "we are all friends," is not exactly the appropriate relationship between independent auditor and client. Recall that Allgyer, the Andersen audit partner had a "personal style that . . . fit well with the Waste Management officers."

The Commission noted:

> It would be impractical to for us to recommend that companies be prevented from hiring individuals who were previously employed by a public accounting firm regardless of whether a client relationship existed.[25]

[23] Panel on Audit Effectiveness at 5.10.
[24] Report at 60.
[25] Report at 101.

The Commission said no more about this issue. However, there should be a safeguard against its getting out of control. Management should be required to notify and receive advance approval from the audit committee whenever a former auditor is engaged in a financial management position.

Require Auditors to Evaluate the Financial Statements as a Whole

The Commission recommended:

> Present standards require the auditor to use judgment to see that the selection and application of particular accounting principles do not produce a misleading result. He should exercise a similar judgment in evaluating the cumulative effect of the selection and application of accounting principles. This is the only position consistent with the views expressed by regulatory agencies and the courts that auditors have an obligation to go beyond determining technical compliance with specific accounting principles and to evaluate the overall presentation of earnings and financial position in the financial statements.[26]

This recommendation, which has never been accepted, was called the "Smell Test" by Commission member LeRoy Layton.

The profession's position is:

> The independent auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of Generally Accepted Accounting Principles. Without that framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements.[27]

Professional standards do require the auditor to evaluate the aggregate effect of uncorrected misstatements on the financial statements as a whole.[28] Layton's "Smell Test" calls for a broader look at the financial statements. It is possible for financial statements to be "unfair," even if there are no misstatements and they are generally in conformity with GAAP. For example, it appears that Enron's accounting for certain energy contracts in accord with SFAS No. 133 (on derivatives) and other transactions greatly inflated the Company's apparent total size.[29]

This recommendation was in accord with a general theme that runs through the Cohen Commission report; auditors must be made to exercise more independent judgment. As Enron has demonstrated, specific accounting rules cannot keep pace with the rapid evolution of business practices and the ingenuity of determined managements. The last line of defense of fair financial reporting is a well trained, informed auditor exercising independent judgment.

Auditors Should Always be Required to Determine that Accounting Principles Selected by Companies are "Preferable"

When the Commission issued its report, and today, companies are only required to apply Generally Accepted Accounting Principles that are *acceptable.* If acceptable alternatives exist and a company is applying one of them, there is no requirement to determine whether one of the acceptable alternatives is better. It is only when a company *changes* accounting principles that a preferability test is required. The Commission noted:

> When management decides to change an accounting principle, use of an alternative must be justified on the basis that the new principle is preferable.[30] If the required justification were not given, the auditor would be expected to qualify his opinion. However, the auditor's evaluation of management's choice among alternative principles should not be different simply because there has been a change. The auditor should have the same obligation to analyze the underlying facts and circumstances for accounting principles for which alternatives exist even in the absence of a change.[31]

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[26] Report at 21.
[27] AU 411.03.
[28] AU 312.34.
[29] In theory, an auditor might take an exception under Article 203–1 of the AICPA Ethics Code saying that it was inappropriate to apply GAAP in a particular circumstance, but the "Smell Test" is a broader concept. The Enron example cited here probably does not qualify for Article 203 treatment since "an unusual degree of materiality" is specifically cited as not being a reason to apply Article 203.
[30] APB Opinion No. 20, para. 16. A similar requirement is found in the SEC's Accounting Series Release No. 177.
[31] Report at 20.

This would appear to be a simple suggestion, not subject to a great deal of debate. When alternatives exist, the company must always use the *preferable* alternative. The Commission logically modified its recommendation to exclude those situations where authoritative bodies or extensive analysis had given full consideration to a particular set of alternatives and could not determine that one was preferable.

Nevertheless, no action has been taken on this suggestion since the Report was issued in 1978.

This issue relates also to the question of independent accountants giving advice on the structuring of certain transactions. It is legitimate and probably desirable for an auditor to give a client advice on structuring new transactions so that the accounting for the transaction will be acceptable. However, it is not desirable for that advice to produce accounting that is "barely acceptable." A preferability standard should apply to advice as well.

Require Companies to Record All Audit Adjusting Entrees Regardless of Materiality

Materiality is the most powerful of all elements in GAAP. Every Statement issued by the FASB (and its predecessors) includes:

> The provisions of this Statement need not be applied to immaterial items.

In effect, a materiality decision—or more precisely, a decision that a matter is not material—may outweigh the most authoritative accounting standard or the most egregious accounting. Recall the bizarre accounting in the quotes above from the SEC's Release on Arthur Andersen. The Andersen partners accepted it on the grounds that it was "immaterial." Yet, there is no practical, clearly applicable definition of materiality. The standard definition is:

> The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

This definition was cited by the AICPA in SAS No. 47, by the FASB in Concepts 2 and by the Canadian Institute of Chartered Accountants. It does not provide an adequate basis for making practical accounting decisions; it is essentially a legal construct. In March 1975, the FASB issued a discussion memorandum "An Analysis of Issues Related to Criteria for Determining Materiality." In 1978, the Cohen Commission said:

> The FASB has recently put on its agenda the topics of materiality and . . . We encourage prompt completion of the projects because of their importance to the development of more definitive statements of accounting principles and auditing standards.[32]

The FASB has promulgated no additional work on materiality since 1975.

The better definition of materiality is critical to better auditing standards and stronger regulatory control. Almost every significant accounting action brought by the SEC hinges on whether the alleged misstatements were "material."

I have little hope that my testimony here will result in any progress on the general issue of materiality, after more than a quarter century of inaction. However, there is one significant step in the area that can be taken by regulatory action, by the SEC or, if established, by the NFRB.

Consider the following exchange:

Auditor: We believe you should book this adjustment reducing revenue.

Client: You are right theoretically, but I would rather not. The consolidation is almost finished.

Auditor: We still think you should adjust.

Client: No. Besides, your adjustment is only 2 percent of net income for the period. It is not material.

Hypothetical? Uncommon? No. Most experienced auditors have encountered this situation. So has the SEC. On September 28, 1998 the Chairman of SEC gave a speech at New York University, noting:

> But some companies abuse the concept of materiality. They intentionally record errors within a defined percentage ceiling. Then they try to excuse the fib by arguing that the effect on the bottom line is too small to matter. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly. . . . "It doesn't matter. It is immaterial."

[32] Report at 16.

Whether many auditors are quite as pliable as the Chairman implied is questionable. In practice, the outcome of such confrontations varies depending on many factors, not the least of which is the personalities and the character of the relationship between the auditor and the client. One fact is certain, however: The auditor gets little help in dealing with this problem from the profession's authoritative literature. The recently issued SAS No. 89 requires the audit committee be informed of uncorrected misstatements that are deemed immaterial, but not that they be corrected.

I propose a simple, straightforward standard which I believe would provide guidance in many of the situations described above. The substance of the proposed rule is: *Discovered* misstatements must be corrected.

The new standard could be promulgated as either an accounting or an auditing standard (or both). Its rationale is simple: Today, there is negligible incremental cost—in terms of time or money—associated with making an audit adjustment anytime before the financial statements are printed. In the digital age, worksheets and financial statements reside in computers. The $149 accounting program in my laptop computer will, when given an journal entry or other correction, instantly and completely revise all the resulting financial statements. The software used by corporations and auditors is certainly no less versatile.

Thus, arguments that it is too difficult or too late to record audit adjustments have vanished in the computer age. It is time to promulgate a materiality standard that reflects this reality.

Reinvigorate the Accounting Profession

As I have said several times earlier in this testimony, the accounting profession has become less professional in the last several decades. Through the 1960's, the best and the brightest of the professional accountants led the accounting firms, filled the seats on the standard setting bodies and taught accounting students.

Thereafter the accounting world began changing. Management of the accounting firms gradually passed to those who could bring in business. The technicians were eased out of management and essentially became consultants to the staff accountants who were themselves less able to deal with the increasingly complex accounting literature. Control of the standard setting function at the FASB became independent of the profession.

New accounting professors were increasingly drawn from the ranks of Ph.D's who never practiced accounting and could, therefore, not become CPA's. Academic accountants grew increasingly apart from the profession, most occupied with research unrelated to problems and issues of the profession and financial reporting. Increasingly, accounting was taught in colleges and universities as support for management, rather than as a profession.

Establish Graduate Professional Schools of Accounting

The most obvious of these problems (in 1978) was:

> A student who graduates from a high-quality liberal arts undergraduate college cannot generally obtain an equally high-quality graduate professional degree in accounting.[33]

It was clear to the Commission in 1978 that the lack of a graduate professional option was weakening the profession. In the past quarter century, the problem has grown worse as an increasing portion of students defer their career choice until they graduate college. They can then attend graduate schools in law, medicine, business, architecture, physical and social sciences, pharmacy and others, but not accounting.

Without a graduate option, the accounting profession has cut itself off from a growing portion of the best brain power. It is in essentially the same position as single sex colleges, men or women only, who gradually realized that they were closed to 50 percent of the student pool. They opened their doors to the opposite sex.

The Cohen Commission called for the establishment of graduate professional schools of accounting, following the law school model. However, it offered no suggestions on how such schools might be started or financed. This is not a problem that is susceptible to Federal legislation or regulatory action. However, after considering the issue, it might be useful to call for State boards of accountancy, which set entry requirements, to increase educational requirements or offer incentives to graduates of such accounting schools.

[33] Report at 89.

Close the Gap Between Accounting Academics and the Profession

As discussed above, most accounting professors have little interest in or ties to the profession. This gap has had an adverse impact on the profession. The Commission noted:

> One of the roles of the academic arm of a profession is to serve as the conscience of the profession. Academe provides opportunity for reflection and study not permitted to the practitioner; the professor need not fear the loss of a client when he makes a statement critical of current practices. During the hectic years of the 1960's . . . most members of the academic community remained silent. Only a few professors were openly critical of those accounting and reporting abuses that gave rise to much of the present criticism of the profession.[34]

The situation has not changed. The academic accounting community still remains almost mute about the current problems of the profession. Again, the establishment of graduate professional schools of accounting, with professionally oriented faculties, would appear to be the most likely solution.

PREPARED STATEMENT OF ARTHUR R. WYATT, CPA

FORMER CHAIRMAN, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS' ACCOUNTING STANDARDS EXECUTIVE COMMITTEE
FORMER CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE
FORMER PARTNER, ARTHUR ANDERSEN & CO.
PROFESSOR OF ACCOUNTANCY EMERITUS, UNIVERSITY OF ILLINOIS

MARCH 6, 2002

Chairman Sarbanes, Ranking Member Gramm, and Members of the Committee:

I appreciate your invitation to testify before the Senate Committee on Banking, Housing, and Urban Affairs on Wednesday, March 6, 2002, and to submit in advance of that date my comments on the issues raised by recent failures in financial reporting by public companies, deficiencies in accounting standards, and inadequate oversight of the accounting profession.

While I am mostly retired at the present time, I have served about 25 years as a partner of Arthur Andersen & Co. and have been a member of the Financial Accounting Standards Board, a member and Chairman of the American Institute of Certified Public Accountants' Accounting Standards Executive Committee, and a member and Chairman of the International Accounting Standards Committee. My comments to follow are based upon my experiences with those entities, as well as my observations of the accounting profession as an academic and as a consultant to attorneys in litigation concerning accounting issues.

I intend to address the following areas in my comments: The need for attitudinal changes within the major accounting firms, the need for a higher level of quality assurance, both within the accounting firms and by outside overseers, the need for certain restrictions on the range of services that public accounting firms should be permitted to provide to audit clients, the need for continued improvement of the Financial Accounting Standards Board, both in structure and in processes, the need for audit committees of boards of directors to become more proactive in the financial reporting process, and the need for reconsideration of existing accounting profession disciplinary structures.

Before dealing with these issues, however, it may be helpful to provide some background on the evolution of the large public accounting firms over the past 35 years. My observation is that over this period the attitude of the leadership of the large accounting firms has gradually shifted from emphasis on the quality of accounting and auditing services provided to clients to emphasis on growing top-line revenues. While this change in emphasis has been a considered one by the firm leaders, the change has been an evolutionary one, more a gradual process than tied to any identifiable events. Competitive forces within the profession led firm managements to strive for growth, largely by increasing the range of services provided. The focus on growth in revenues altered attitudes within the firms as to the primacy of the quality of the accounting and audit services provided.

I suspect that the various firm leaders would deny that such a change has, in fact, taken place. But the issue is not whether firm leaders intended to alter the emphasis on the quality of accounting and audit services. Rather, the issue is whether a

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[34] Report at 86. One of the few vocal critics during that period was Professor Briloff who is scheduled to testify before the Committee.

heightened focus on expanding the range of services provided (in order to generate increased revenues) acted to diminish the focus of partners and managers on the quality of accounting and audit services provided. Firm leaders would likely argue that they have never purposefully deemphasized the primacy of quality of accounting and auditing services. The facts would show, however, that attitudinally a gradual change has occurred. Thirty-five years ago the leaders of most, if not all, the major accounting firms at that time were well-recognized technical experts, individuals for whom quality of service and outstanding professionalism in its delivery were paramount. That attitude was conveyed to younger partners and staff in a variety of ways, including educational and training programs. Furthermore, younger partners and staff could observe that advancement and salary increases went to those deemed to deliver best high-quality technical and professional services in the accounting and auditing arena.

Today, the large firms continue to have a high level of technical expertise and continue to emphasize quality of services provided. Even so, the most technically competent individuals are no longer recognized as the principal leaders of the firms. Rather than being leaders of the various firms, these experts now are less visible within the accounting profession and, to some extent, even within their individual firms. The firm leadership roles have been assumed by individuals whose expertise lies in administration and/or marketing or promotional activities. By this observation I make no value judgment as to which type of background best prepares one to lead the complex accounting firms as they exist today. Rather, my point simply is that on a relative basis those with the greatest technical skills and a greater focus on high-level professionalism have a lesser role and a lesser visibility within the firms than was true 35 years ago. This relatively diminished role affects attitudes within the firms about the relative importance of quality of service provided and growth in firm revenues.

I do not intend to imply that the leaderships of any of the accounting firms intended to trade off revenue growth for quality of service. I have no evidence that any such intent has existed, and, in fact, I would argue that such intent was not purposeful. Rather, firm leaders made a series of decisions over the years to grow their practices, a phenomenon clearly consistent with the direction taken by most commercial enterprises in the country. The result of these decisions, however, has been to create large commercially-oriented accounting firms when the franchise granted to these firms (through the State-monitored licensure of individuals permitted to attest to the fairness of presentations in financial statements) was more a professional service orientation than a commercial one.

The Attitudinal Issue

The impact of this attitudinal change within the firms has been significant in my view. No longer is technical expertise and leadership the obvious avenue to progress within the firms. Rather, expansion of clients served and expansion of client services are viewed as primary drivers. And, obviously, the loss of a client is a negative in one's career path. Since many decisions required of audit firm managers and partners are judgmental in nature, rather than clearly prescribed by extraneous forces, such judgments are, at the margin, sometimes influenced by perceptions of the attitudes of leaders of a given firm. If those perceptions by firm audit personnel are that loss of a client is damaging to one's career path, the judgments made may be more in the direction of keeping the client than to achieving fair presentation of financial statements.

This change in attitude also has had a significant impact on the nature of new hires into the large accounting firms. Thirty-five years ago nearly all new hires by accounting firms for their professional staffs were college graduate accounting majors whose education not only encompassed technical accounting and auditing issues, but also emphasized professional and ethical responsibilities required of an accounting professional. As the firms grew and the range of services offered by auditing firms expanded, college accounting majors were no longer plentiful enough to serve the needs of firms, and they no longer possessed all of the skill sets needed to provide the expanded range of services. The major auditing firms turned increasingly to nonaccounting majors, bright students regardless of their field of study, for some of their new hires.

While these new hires were talented in many respects, their understanding of the professional responsibilities of reporting auditors and the ethical constraints under which their work would be undertaken was limited, if not nonexistent. Individuals with such backgrounds might be more reactive to the attitudinal changes previously mentioned.

Similarly, educational institutions struggled to modify their accounting-major programs to better fit the perceived needs of the major accounting firms. In fact, many

of these academic modifications were urged upon the academic community by the large auditing firms. While exceptions could be cited, the emphasis on professionalism and ethical responsibilities diminished in a relative sense. Accounting programs employed as accounting professors some individuals with little or no educational backgrounds in accounting and were not particularly receptive to employing experienced professionals who might convey to students in an effective way professional and ethical responsibilities to be assumed by one entering the accounting profession.

The effect of this relatively increasing emphasis on commercialization and relatively diminishing emphasis on professionalism tends to diminish efforts to maintain a strong professional focus that a professional firm may otherwise strive to promote. Recognizing that accounting and auditing services are more an art than a science, it should not be surprising at all that from time to time individual accounting practitioners, no matter how complete their training, would, for any number of reasons, fail to perform their professional duties at the level of competency their clients, the public, and the firm managements had a right to expect. For professional accountants to reach sound judgments in a professionally responsible way, their work environment, including the attitudes projected from the top of their firms, needs to be as unequivocally professional as possible.

While my comments on the scope of services provided by public accounting firms will follow, I believe that the leadership in the various firms needs to evaluate how well their existing organizational structures and reward policies are serving what has to be their primary focus, the delivery of high-quality professional accounting and auditing services to clients. While these observations may not be very helpful in considering legislative initiatives, I believe they are crucial for the major accounting firms to address if the firms wish to survive in the private sector as respected reporters on the financial situation and results of operations of business enterprises.

Improvement in Quality Assurance

Large accounting firms have similar programs to try to assure audit quality control. Even so, the increased number of financial statement restatements in recent months suggests that existing quality control programs need to be strengthened. The emphasis on quality control needs to be heightened, and audit personnel need to gain a better appreciation for all aspects of a firm's quality assurance program. Renewed emphasis on the importance of audit quality control mechanisms would be an important part of shifting the attitude within accounting firms to a proper focus on the quality of financial reporting.

As individual firm quality control experts evaluate the work of individual partners and managers in their numerous offices, special efforts need to be made to review high-risk clients and/or clients utilizing high-risk transaction forms. Likewise, quality control experts need to assess specifically the extent to which individual managers and partners address difficult client issues from the perspective of fairness of financial reporting. Specific challenges should be made of judgments by audit managers and partners that adjusting entries proposed by them and not recorded by the client are acceptable from the perspective of achieving fairness in the resulting financial statements. Quality control experts within the firms should seek out any evidence that suggests financial reporting by the client entity is not reflective of the transactions and events that occurred. Whenever such evidence is found, the appropriate resolution must be pursued even when the end result could be the loss of a client.

Changes implemented in this area are in the best interests of the firms and, in the current environment, are likely to be instituted quickly on a voluntary basis. Recent news articles suggest some of the large firms have undertaken numerous initiatives on such matters. An independent oversight board, as discussed later, should monitor such changes to satisfy themselves that appropriate policies are in place to assure high-quality audit efforts.

Expansion of Range of Services

The evolution of the drift toward increased emphasis on commercialization and reduced emphasis on professionalism led the large accounting firms to expand the range of services provided to their audit clients. Importantly, however, we must acknowledge and emphasize that accounting firms have always provided their audit clients services that extend beyond the activities required in an audit to complete the formation of an opinion on the fairness of presentation in the financial statements. Many of these services are logically best provided by the audit firms—tax return preparation and tax planning, evaluation of accounting alternatives for planned transactions, assistance with financial statement preparation for regulatory purposes, audits or reviews of prospective acquirees in business combinations are examples. Indeed, any additional services that are directly related to assuring the

fairness of presentation of client financial statements are proper activities for audit firms to undertake. Services of these types are often closely related to, and helpful in, the successful completion of financial statement audits. They supplement the knowledge base of audit personnel and do not conflict with the central mission of auditors—forming an opinion on the fairness of presentation of client financial statements. Restrictions imposed on these types of services would create inefficiencies for clients and would not be in the best interests of investors or the financial or business community.

On the other hand, as the range of services provided broadened, some were clearly creating potential for conflicts with the basic audit services. While I am unaware of any evidence that consulting-type services have ever adversely influenced an auditor's audit judgments on decisions, the fact is that today existence of some services creates an appearance that can no longer be tolerated. For example, rendering internal audit services for audit clients was never a sound idea. Likewise, services related to the design of financial reporting systems place the auditor in an awkward position if the system does not function as anticipated. Actuarial services, executive searches, advice on specific investment decisions and many more services of this nature that evolved over the years to generate increased revenues but either have little relationship to the annual audit or may create conflicts of interest should no longer be permitted by audit firms for their audit clients.

The range of services provided by audit firms to their audit clients grew for a variety of reasons. One was the leaning toward commercialization previously mentioned. Another was recognition by firms that their personnel possess skills that extend beyond those needed to complete audits successfully. Another was a desire, and ability, to fulfill requests by clients for additional assistance. As investment bankers and other financial advisers created increasingly complex business transactions (some designed to circumvent existing accounting standards), clients logically asked their auditors for assistance in evaluating the consequences of undertaking such transactions.

Consistent with the reestablishment of professionalism as the primary focus of auditing firm services, restrictions need to be imposed on the range of related services that auditors should be authorized to provide their audit clients. Drawing lines in this area will not be an easy task, largely because words used are not always interpreted in the same manner by all those who have to interpret them. Given the current environment, it is certainly possible that some regulations or legislation will suggest scope of service restrictions that will damage the auditor's ability to develop the best possible basis for expressing an opinion on the fairness of presentation of the client's financial statements. Initiatives in this area need to be undertaken, but they must be undertaken with care so that they do not frustrate the auditor's ability to complete top quality audit services.

Self-policing mechanisms have not worked well, and the Securities and Exchange Commission, audit committees or a newly created independent oversight body may have to play a significant role in this area. Regardless, attempts to regulate the range of acceptable services that audit firms may provide their audit clients likely will be frustrated without leadership in the several firms willingly agreeing to move away from their commercialization instincts and reemphasizing the primacy of meeting professional standards in all respects.

Accounting Standard Setting

The Financial Accounting Standards Board, FASB, is soundly conceived and has operated reasonably well given the difficult environment it faces. Two principal criticisms of the Board's standards are that they are not always conceptually sound and that they take too long to produce from inception of a project to release of a final standard.

The Board has a conceptual framework that it utilizes in developing positions on an accounting issue under consideration. That framework is reasonably cohesive and has served the Board well. Even so, the Board needs to recognize that its conceptual framework is a living document that will require modifications from time to time as accounting and economic concepts evolve. Improvements in its conceptual framework should have a high priority for the Board.

Too often the Board has departed in its final standard from the concepts that it has represented will guide its decisions, generally because interested parties have not only raised objections to conclusions tentatively expressed, but also have effectively lobbied against adoption of those decisions the Board has signaled. Such departures are not surprising given that the processes of the Board are open, with public meetings, public hearings, and Exposure Draft issued requesting comments from interested parties. While the comments received through these open processes are often helpful in the crafting of a final standard, too often the criticisms are not

conceptually based, but rather are emotional in nature, reflecting a dislike for the direction the conclusions are taking. Thus, the Board often modifies, or softens, its tentative conclusions to reflect some of the concerns expressed in the due process procedures.

The due process procedures are soundly conceived and essential for the Board to achieve a desirable level of credibility for its standards. What is needed is a greater discipline by those participating in the process to direct their comments to weaknesses in the Board's reasoning processes and to eliminate the emotional criticisms that have no logical basis. If the accounting standard setting process is to achieve its objectives of providing guidance on appropriate accounting for transactions and events of an entity, the process must be recognized by all participants as being primarily an intellectual process and not primarily a political process.

As long as the Board is willing to depart from its underlying concepts in order to gain some measure of concurrence with the views of its constituents, it will issue standards that will not survive for long periods without being abused. The Board often receives negative comments from industry constituents, from auditing firm representatives, from Members of Congress, as well as others. When these comments become part of an organized campaign to undermine the direction a standard is taking and recommend alternative conclusions that are not conceptually sound, the mission of the Board is frustrated. This is particularly true when the intervenors are Senators and Representatives who, as part of their commentaries, threaten some type of legislation to frustrate the direction in which the Board is moving. While Senators and Representatives have a legitimate interest in the workings of the Board, they need to recognize that their interventions may well lead to Board decisions that are not in the best interests of investors and the broad business community. Being supportive of the views of constituents and contributors, without making conceptually sound alternative suggestions, too often creates opportunities for interpretations of the resulting standards that are not in the long-term best interests of any parties.

The time interval required for the Board to promulgate a standard has long been a concern of the Board itself, as well as other interested parties. A great contributor to the lengthy process is the open due process procedures that the Board employs to assure that all interested parties have an opportunity to provide commentary. Such due process procedures are generally well conceived and serve the overall standard setting process well. On the other hand, those who dislike the direction a project is taking, whether Board members themselves or Board constituents, probably have too great an opportunity to effect delay by calling for additional research in order to buy time to lobby against the direction they perceive the process is moving. The Board may well need greater discipline in this area and the willingness to simply move forward at earlier points in the process than has been the case in the past.

Even with improvements in recent years, the Financial Accounting Foundation trustee arrangement remains problematical. The trustee group would benefit from heavier reliance on individuals independent of the accounting firms and companies that provide a share of the Board's finances. The challenge is to identify public-minded individuals who are willing to devote the necessary time to meeting the trustees' two main areas of activity—identifying and appointing competent Board members and raising sufficient finances to permit the Board to operate effectively. While the current financing mechanism could be tinkered with, no individual entity currently contributes a significant portion of the Board's budget. I am unaware of any instance in which any Board member's vote on an issue was influenced by the position taken on the issue by a contributor. I believe with the proper composition of the trustee group the issue of independence of the trustees would be resolved. Alternative means for financing required by the Board may be considered, but I do not view the present mechanism to be troublesome as long as major contributing groups are not represented as trustees of the Financial Accounting Foundation.

For the Board to be able to continue to improve the quality of its standards the Board needs to place increasing reliance on its underlying concepts, avoiding to the extent possible standards that compromise those concepts. Standards that are conceptually sound need not run hundreds of paragraphs to thwart those who would attempt to subvert the intent of the standards. Each standard issued by the Board should contain, in the clearest English possible, the objective, or intent, the Board intends to achieve by issuing the standard. Each standard issued by the Board should also contain a clear statement that anyone who is applying the standard should review carefully its application to satisfy himself or herself that the objective specified by the Board has, in fact, been best achieved through the application that has been adopted.

I am convinced that the FASB process is soundly conceived, that the Board members over the years have been dedicated professionals of great integrity and independence, and that the quality of accounting standards today is better than it has ever been, even with the shortcomings that some standards contain.

In summary, the financial standard setting process is an evolutionary one that has grown stronger over the years. Continued improvement in the areas outlined would strengthen the process further. Finally, if constituents would refrain from emotional criticisms during the due process period and if Senators and Representatives would refrain from interventions that are perceived by the Board as being heavy handed and politically, rather than intellectually, based, the accounting standard setting process will continue to improve and serve investors and the investment community better than any alternative structure.

The relationship between the FASB and SEC over the years has been a positive one which benefits investors and creditors. While each organization has a different mission, each has the same end objective in mind. Continued cooperation between these two entities is in the best interests of investors and creditors.

Audit Committees

The requirement for public companies to have audit committees of the board of directors is a relatively recent phenomenon. Through interventions of numerous parties, most importantly the Securities and Exchange Commission, audit committee requirements and procedures have been modified, and upgraded, over the last several years. Even so, my experience (mostly as a consultant to attorneys in litigation matters involving issues of accounting) is that audit committees remain far less effective than they could be or ought to be. Audit committee members need to focus importantly on the various risks faced by their company, including accounting risks related to the possibility of improper accounting for new and/or complex business transactions.

While financial statements can be misleading in a variety of ways, most deficient financial reporting matters fall into four areas: The timing of revenue recognition, the propriety of cost deferral, the omission from the balance sheet or related footnotes of any significant obligations, and the adequacy of disclosures, particularly any that may center or related party transactions. Audit committees need to question corporate financial accounting personnel in depth about such matters and the risk of possible financial misstatements. Likewise audit firm representatives need to be similarly questioned. In addition to routine agenda matters, each audit committee meeting should focus on a particular business risk area (including potential accounting risks) and any significant concerns emerging from such discussions need to be aired further with the full board of directors.

At least the audit committee chairman, and preferably all audit committee members, should have experience in evaluating business risks and should be sufficiently conversant with accounting issues to raise appropriate questions with an ability to evaluate the responses received. Too often audit committee meetings are perfunctory in nature. Real opportunities to gain an understanding of business risk areas are missed. As a result the process in place is not as effective as it could be, nor as effective as those who accomplished the establishment of audit committees had a right to expect such committees would be.

Audit committees should be especially curious about the so-called adjustments proposed by auditors but not made by company accounting personnel. Oftentimes the basis for the company not making the entry is that the amount involved is not material. Materiality is an elusive concept that is even more elusive in practice. Audit committees should pressure company accountants and the auditors to resolve any open proposed adjusting entries either by the company accepting the entry for recording or the auditor concluding that the proposed entry should be eliminated from its schedule of open proposed adjusting entries. In too many instances the materiality judgments made have masked what, in fact, was inappropriate accounting, accounting that fell outside Generally Accepted Accounting Principles.

The audit committee concept is a sound one. Through efforts of the New York Stock Exchange and the SEC improvements in committee composition and mission should continue to evolve. Honest managements and responsible auditing firms should welcome audit committee involvement when such committees are constituted properly, with knowledgeable individuals willing to gain an understanding of the underlying business risk issues and raise questions on appropriate accounting and disclosure matters.

Disciplinary Mechanisms

My experience with this issue, as well as my knowledge base is sparse. The current mechanism, under the auspices of the American Institute of Certified Public

Accountants, however, clearly is not working. Over the years the AICPA has become more and more a trade association and less and less a professional organization. The diversity of interests of its members, from sole practitioner to large-firm partner, to corporate executive makes it almost impossible for the AICPA to exercise leadership and articulate policies that one would expect of a professional organization. Its emphasis has been on expanding its breadth of membership rather than on providing leadership in professional practice areas or disciplinary policies that would be effective.

Suggestions have been made recently for creation of a new independent oversight board comprised of leading individuals independent of the accounting profession. While the AICPA sponsored Public Oversight Board has been comprised of highly regarded individuals, its effectiveness has recently been questioned. Who should be the "parent" or "owner" of such a board is a difficult issue that I have no particular insights in resolving.

Over the years the Securities and Exchange Commission has been a generally effective agency working toward improvements in financial reporting. Even so, its resources have probably been far too limited to achieve the optimum level of success in its diverse objectives. I would be inclined to provide increased funding to the SEC and have it assume the principal role in overseeing the effectiveness of the financial reporting process. Creation of a new agency to undertake this responsibility seems unnecessary in view of the record established by the SEC over the past 65 years.

In summary, I feel that the leadership of the major accounting firms should see today that it is clearly in their best interests to refocus their objectives on quality professional performance and to refrain from growth through expansion of services rendered. New restrictions on scope of practice, possibly monitored by the SEC, are desirable and in the public interest. The FASB should place increased emphasis on conceptually sound standards and on more timely issuance of such standards. The Board should experiment with how better to craft its standards so that corporate accountants and auditors will be encouraged to apply the standards so as to best meet articulated objectives of the standards rather than to search out and expand possible loopholes that lead to applications that fail to reflect the economics of transactions undertaken. The Board should continue its efforts to rebuff initiatives of its constituents, including elected officials, when such initiatives are more emotionally than conceptually based. Audit committees should be encouraged, possibly by the New York Stock Exchange and the SEC, to be more diligent and effective in overseeing corporate risk exposures and accounting policies that accord fully with the intent of applicable accounting standards. Finally, improved disciplinary and oversight mechanisms on professional practice firms need to be instituted so that variant behavior is identified early and punished if not corrected.

PREPARED STATEMENT OF ABRAHAM J. BRILOFF

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MARCH 6, 2002

Accountancy and Society / A Covenant Desecrated

The Commission is fond of quoting Judge Friendly's statement: "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." U.S. Circuit Judge Henry Friendly, *United States* v. *Benjamin* 328 F2 85, 863 (1964).

Chairman Sarbanes, Members of the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate: I very much appreciate this opportunity of appearing before you this morning to share with you my views regarding the crisis in confidence which presently confronts my profession of certified public accountancy and then to suggest what I believe to be the essential critical path to resolve that crisis.

After much reflection I have opted for the title theme for today's presentation, "Accountancy and Society/A Covenant Desecrated." I recognize that I have thus opted for an awesome theme; I mean it to be just that, i.e., most certainly not a mere rhetorical conceit.

The Covenant

The covenant to which I am alluding involves on the one hand the mandate which is imposed on certified public accountants by the statutes which created that profes-

sional license; from the New York Statutes going back to the close of the 19th Century. Definition:

> The practice of the profession of public accountancy is defined as holding one's self out to the public, in consideration of compensation received or to be received, offering to perform or performing for other persons, services which involve signing, delivering or issuing or causing to be signed, delivered or issued any financial, accounting or related statement or any opinion on, report on, or certificate to such statement if, by reason of the signature, or the stationery or wording employed, or otherwise, it is indicated or is implied that the practitioner has acted or is acting, in relation to said financial, accounting or related statement, or reporting as an independent accountant or auditor or as an individual having or purporting to have expert knowledge in accounting or auditing.

On the other hand there is the very special franchise granted to the accounting profession by a 3 to 2 vote of the Securities and Exchange Commission at its inception, that requiring all registrants to submit statements audited by accountants in the private sector rather than by employees of governmental agencies. That special franchise is generating revenues amounting to billions of dollars annually.

Why the Covenant

This covenant was undertaken between my profession and society for most compelling reasons—reasons which have been increasingly compelling with the passage of time and the corresponding expansion exponentially, it might appear, of our economic society and complexity of our corporate enterprises. It is to assure the effective functioning of capitalism powered by the corporate complex which demands an effective system of corporate governance and accountability—and it is to help drive such a process that the covenant was entered into by society with my profession.

Let me back up a bit: I believe it to be self-evident that in the day-to-day existence of our citizenry the private sector of corporate complexes plays a far more direct role than the Government. Thus, the air we breathe, the recreation we enjoy our mode of mobility, our habitats, health, and economic well-being are all impacted by decisions by those who somehow, somewhere control the conduct of corporate enterprises.

Here then is where we meet up with the Power without Property Syndrome, described early in the 20th Century by Gardner C. Means and later expanded by Adolf A. Berle. Thus, enormous pools of power have been delegated to managements by those who are the owners of the resources, that is, shareholders, creditors, Government, employees, *et al.*

To assure those who have thus delegated their resources to managements we have conceptually, at least, built in a system of checks and balances, a system of corporate governance and accountability. I picture that system as a series of concentric rings, somewhat as follows.

The Corporate Governance and Accountability System

At the vortex of the constellation is management, the very center of power of the corporate complex. The first of the outer rings in this configuration is the board of directors whose authority is derived from the shareholders and presumed to be responsible for determining the policies of the corporate enterprises and then reviewing their operations to assure their constituencies that the policies are, in fact, being fully and fairly implemented.

There then follows an especially critical sector, the independent audit committee of the board of directors. Here, too, those who have been elevated to this special role and responsibility should be continuously aware of the reasons why such a committee has become such a vital force in our corporate governance and accountability process. They should be continuously mindful of the terms "independent" and "audit" and make certain that they possess the temperament and healthy skepticism called for by the standards governing independent audit committees. Thus, those committees were mandated first by stock exchanges and then by the SEC in response to critical developments over the years; it is only if the members fulfill their roles conscientiously and professionally, determined to act as watchdogs rather than managements' lapdogs, that they will be fulfilling the very special mandate which has been bestowed on them and presumably accepted by them.

This now brings me to what is for me the crucial ring in this constellation, that of the independent auditor, the one who has entered into the covenant with society; the one who is presumed to have undertaken the role and responsibility of probing the conduct of all aspects of the corporate enterprise as the surrogates on behalf of the world of third parties.

In short, those are the qualities which our society had presumed of the independent auditors as an incident to the entering into the covenant. Absent those qualities, anything which compromises those expectations represent a breach, a desecration of the covenant.

This brings us to the ring to representing the nexus of State and Federal agencies involved in the regulation of the corporate complex. At the outset, we have the States which bring the business enterprises into existence by the granting of corporate charters or licenses as appropriate.

It is also the States which bestow the licenses for the various professional pursuits, accountancy, law, etc., which may be involved in the corporate governance and accountability process. But of special import for present purposes are the regulatory agencies, Trade, Utilities, Transportation and, especially for us here today, the Securities and Exchange Commission which is charged with the administration of the Securities Acts of 1933 and 1934, and the source of Regulation S–X providing the rules governing the registrant's accounting responsibilities and practices. It is undoubtedly the SEC which comes to mind regularly during these days of agonizing appraisal and reappraisal as to what went awry at Enron—and wherever else accounting irregularities are now surfacing with regrettably increasing frequency.

The next succeeding ring is the Congress of the United States which over the scores of years since the Great Depression has, through its Investigative and Legislative actions critically, vitally, impacted the standards for corporate governance and accountability.

We move outward then to the Judiciary, principally the Federal courts which through their determinations in civil and criminal proceedings further define the standards for conduct of all those involved in the corporate enterprise.

This would complete the corporate governance and accountability configuration as I envisage it. But then too at each of the stages of the process we find the professions of the law, finance, journalism, academe, in addition to accountancy beyond that of independent auditing. All of these phases when functioning optimally consistent with their professed objectives should assure the effective functioning of our corporate enterprise system which, as I have emphasized, is the engine which propels modern capitalism system. If this system of interrelated responsibilities fails, we have the Enrons, *et al.*

Some Footnotes to History

In the hope that it might help to avoid repeating its mistakes, herewith some footnotes to history relating to past endeavors to overcome the recurring crises in corporate accountability.

There was a flurry of activity during the second half of the 1970's, including:

- Late 1976 a staff study dubbed *The Accounting Establishment* was prepared for the U.S. Senate Committee on Government Operations.
- The following year extensive hearings were held under the Chairmanship of Senator Lee Metcalf.

To placate the extensive criticism leveled at the accounting profession its leadership, the AICPA, the Big 8, agreed to what they assured us would be an effective response to the crisis. This included the creation within the AICPA of a Division for Firms especially its SEC Practice Section and Public Oversight Boards; all that together with a system of peer review was going to lead us to Nirvana.

Alas! As predicted, peer review became nought but mutual back scratching; the POB was soon co-opted by the AICPA so that the presumptive public protector became another layer of insulation to protect the Accounting Establishment.

By way of a justification of the foregoing cynical observation, I have regularly challenged the POB and its parent body the AICPA to point me to any disciplinary sanctions meted out against those identified with the Accounting Establishment who have been prominently identified with serious audit failures after audit failures. That challenge continues to the present.

- We then have the Foreign Corrupt Practices Act of 1977 which explicitly directed the effective functioning of systems of Internal Control for all SEC registrants. The SEC proposed regulations to implement the provision's of the FCPA, that valiant endeavor was effectively resisted by the accounting profession and their constituencies—the proposal was withdrawn. (Included herewith as Exhibit A is a critical commentary on these developments which was included in my article "The Private Securities Litigation Reform from a Critical Accountant's Perspective" which appeared in the *Critical Perspectives on Accounting* (1999) 10, 267–282.
- This brings us to 1995 when, as part of the bargain leading to the passage of the Private Securities Litigation Reform Act of 1995, Title 3 was enacted, so as to

require auditors of SEC registrants to probe more aggressively for irregularities or fraud.

As my aforementioned *Critical Perspectives* article also noted the Senate suggested that the new requirements be implemented with only most deliberate speed and so it has been. And as we know from the record of the so-called Independence Standards Board created by the AICPA the more deliberate the better insofar as the Accounting Establishment is concerned.

- And this takes us to the millennium year 2000 when the SEC under Chairman Arthur Levitt and Lynn Turner as its Chief Accountant sought to induce higher standards of independence from the independent auditors of its registrants.

At hearings during the summer of 2000 we witnessed the AICPA and the Big 5 manifesting all of their arrogance of power unless it was their power of arrogance to thwart the SEC's proposals. At the end the SEC did salvage some changes; and especially gratifying as it now turns out is the added disclosure relating to the nonaudit fees.

Quo Vadis?

This brings me to the response to the question, "Where should we go from here?" which, I presume, is the reason for your inviting me to appear before you today.

First, I want to repeat with added emphasis the cardinal recommendation that I made when I appeared before the SEC on September 21, 2000, in connection with their hearings on Auditor Independence to wit:

1. *Absolute* Divestiture, i.e., No "Strategic" or Other Entangling Alliances.

Then demand that the profession of certified public accountancy rededicate itself to the independent audit as surrogates on behalf of all stakeholders. This is the covenant, which we are presumed to have undertaken with society—let us fulfill it.

Such a rededication to the CPA as a professional should put an end to our quest for an XYZ license.

Further, the renaissance of the independent audit as a vital social responsibility should prove salutary for relevant research and teaching of accountancy *qua* accountancy in the groves of academe.

(I have submitted as an Exhibit B for the record a copy of my submission to the SEC as an incident to my testimony at the SEC hearings.)

2. And now, going further I urge that the SEC develop a registry of firms which have fully committed themselves to the independent audit of SEC registrants, consistent with the standards set out above.

By so doing the SEC would be in a position to proceed overtly to impose sanctions or even delisting of firms which have failed in the fulfillment of their undertakings.

3. I would have the independent auditor as an incident to his rounds as such independent auditor apply his presumed "healthy skepticism," corresponding to the way in which he would proceed if he were acting as a forensic auditor in the wake of an accounting disaster.

For example, I recall the circumstances about 4 years ago when I had the occasion to analyze the report prepared by Arthur Andersen as the forensic auditor in the wake of the discovery of the fraud at CUC prior to its merger into Cendant in late 1997. In my analysis I congratulated AA on the ways in which it went about its probe to ferret out the perversity perpetrated by the financial people at CUC and spelled out the errors of omission and commission on the part of Ernst & Young, CUC's auditors.

But then, just as I brought my analysis and commentary to a close, along came Sunbeam where AA as the independent auditor fouled its nest very much like E&Y at CUC. In short, the auditors know what they need to do to produce a product, which could be relied upon by the investor, *et al.* Let them apply their talents in all circumstances where they serve as the surrogates on behalf of the world of third parties.

I am not here suggesting that the auditors become adversaries; but then, I insist that they refrain from the writing of the narrative as though they were writing an "authorized biography." I am searching for a standard of Truth and Objectivity.

4. I would then look for a sea change to conform the actual responsibility for the determination of the financial statements with that which is presently presumed by society generally, including even sophisticated investors. Thus, the community of users of the statements presume that they have been determined by the certifying independent auditor. The actuality is reflected by the following assertions typically found in the Audited reports submitted to shareholders and the other constituencies of the business enterprises.

First, from the auditor's certificate:

Report of Independent Accountants

> "These financial statements are the responsibility of the company's management; our responsibility is to express an opinion on these financial statements based on our audits . . ."

And then the corresponding assertion from the letter from management:

Statement of Management Responsibility

> ". . . management is responsible for the preparation, integrity and objectivity of the consolidated financial statements and other financial information presented in this report."

5. The resultant auditor's report in the form of words and numbers, characterized by clarity, logic, intrepidly, and integrity should convey a description of economic reality as closely as the states of the Arts of Communication, Economics, and Accountancy might allow.

If We Should Fail . . .

What if the required drastic, dramatic possibly draconian, as viewed by some, changes are not implemented promptly and effectively?

All of the foregoing proposals for a response to the prevailing crisis could be seen to have evolved from my 1967 book entitled *The Effectiveness of Accounting Communication.* Justice William O. Douglas honored me by providing a Foreword to that work; some extracts from his essay:

> The author demands an understandably high price of the attesting accountant, who is preparing himself to fulfill this essential role. He expects him to undergo a "ritualistic purging" and to forego the rewards which may be derived from the rendering of a management services and the other "peripheral services" which he describes.
>
> The burdens which Mr. Briloff puts upon the profession are substantial; but, as he demonstrates, our economic society is in urgent need of this service. If the accounting profession does not respond effectively to the challenges presented, there may be little alternative but to have possibly a new profession fill the breach.

(The Justice's Foreword is included in Exhibit B.)

If we find ourselves deadlocked and our economic society continues to be vulnerable then despairingly I would proceed to the proposal advanced 2 years ago during my presentation to the FASB at their hearings on business ago during my presentation to the FASB at their hearings on business combinations. That proposal, as part of my "An Accountancy Manifesto for the Third Millennium" was published in *Accounting Today* and included in Exhibit B. *Accountancy Today* article:

> "I would abort the present requirement that such financial statements carry the imprimatur from independent CPA's. This is because the major firms that are principally responsible for those audits are no longer firms of CPA's, nor are they as independent as they are perceived to be by the financial community.
>
> "As a consequence of these proposals, the determination and implementation of the accounting precepts and practices, which would best reflect the financial condition and operations of the enterprise would become the sole responsibility of management. This is essentially the prevailing reality: The public's myth regarding the independent audit is just that, a myth."

I would then have the financial statements carry the legend *caveat emptor. Coda:* The February 28, 2002, *New York Review of Books* included an essay by Ambassador Felix Rohatyn captioned "The Betrayal of Capitalism," which concluded with the following foreboding:

> "American popular capitalism is a highly sophisticated system that needs sophisticated regulation—whether in finance or in other fields. The Government itself does not seem to have acted illegally in the Enron case; it is the Government's failure to anticipate and prevent what happened that is the problem. Unless we take the regulatory and legislative steps required to prevent a recurrence of these events, American market capitalism will run increasing risks and be seen as defective here and abroad. That could have deeply serious consequences not only for our domestic economy but also for the world economy as well. Enron's failure was a failure of particular people and institutions but it was above all, part of a general failure to maintain the ethical standards that are, in my view, fundamental to the American economic system. Without respect for those standards, popular capitalism cannot survive."

EXHIBIT A

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THE PRIVATE SECURITIES LITIGATION REFORM FROM A CRITICAL ACCOUNTANT'S PERSPECTIVE

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On December 22, 1995, the Congress of the United States, overriding a Presidential veto, enacted the Private Securities Litigation Reform Act of 1995. The objectives of that enactment, which I euphemistically dubbed the "Accountants Relief Act" included:

- Elimination of abusive practices in securities litigation;
- Removing the incentives to participate in a business class action litigation;
- New rules relating to the settlement process;
- Attorney sanctions for pursuing meritless litigation;
- A safe harbor for forward-looking statements or projections;
- Limiting civil Racketeering Influence and Corrupt Organization Actions;
- A grant of authority to the SEC to prosecute certain aiding and abetting cases;
- Limitation on damages;
- Modification of joint and several liability.

Before proceeding, by way of full disclosure, for years preceding the enactment, in testimonies before the United States Senate and House of Representatives, in writings and speeches, I inveighed against the legislative proposals which were then under consideration.

I made clear my opposition to the legislative juggernaut, asserting that by continuing to press for a Congressional enactment to further limit the liability of auditors for their adjudicated professional misconduct the organized accounting profession and their lobbies were demonstrating that they were a most powerful special interest group with unbounded aggression and avarice. I said this because the accounting profession was already most effectively insulated from the consequences of their

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lapses, including:

- The US Supreme Court determination in *Hochfelder v. Ernst* & Ernst 425US. 185 (1976) ("*Hochfelder*") a score of years ago holding that an auditor could be held responsible for his negligence only if it was determined that his conduct approached criminal fraud. That is how I interpreted the Court's *scienter* standard.
- In April, 1994, the Court, in the *Central Bank of Denver v. First Interstate Bank*, 511 US 164 (1994) ("the *Central Bank* case") determined that, despite three score years of at least benign acceptance of the notion that to knowingly aid and abet a fraud could subject the auditor to legal liability, that aiding and abetting notion did not apply. As a consequence, an auditor is now deemed to be culpable only if he is determined to be a primary conspirator or perpetrator; again, why this should not warrant a referral for a criminal probe is beyond me. In an earlier day such involvements have been thus referred, followed by trials, convictions and sentencing.
- In various jurisdictions the auditors have been immunized because the plaintiffs could not demonstrate privity, i.e. direct linkage between the alleged miscreant and the euchred lender or investor.
- More recently the states have enacted so-called LLCs (Limited Liability Companies, Corporations or Partnerships)—again, another protective concentric ring of immunization for the adjudicated miscreants.
- As something of a *crie de coeur*, I concluded my testimony before the US Senate Committee on Banking, Housing and Urban Affairs on 21 July 1993, relating to Private Litigation under Federal Securities Laws on the following note:

The thrust of this presentation can be summed up most succinctly, thus:

> "My profession has failed to recognize, or at least meaningfully to respond to, the responsibilities vested in it by society. To exacerbate that condition the regulatory and self-regulatory process which is required to assure the effective functioning of the profession is severely deficient at all levels. Accordingly, the only meaningful deterrent left to protect society is the 'private attorney general' process, i.e. that of class action suits.
>
> If there are abuses in that process, we must leave it to the courts and, if appropriate, the self-regulatory process in the legal profession.
>
> Until my profession does, in fact, actually meet its professional commitment, by performance rather than promise, I am opposed to the legislative proposal designed to create a system of 'proportionate liability' for negligence, no matter how reckless the negligence, short of criminal fraud".

These endeavors on my part, however valiant, were to no avail. That which follows is hardly an objective evaluation of the 1995 enactment, in fact, it should be read as something of a polemic.

The intensity with which the accounting establishment, pursued this legislation was evidenced by an article in the *Legal Times* for the week of April 17, 1995:

> "Tired of being parties to securities-fraud suits, the giant American Institute of Certified Public Accountants, which sets professional auditing standards and looks after its members' interests on Capitol Hill, has decided to fight back. Along with the Washington offices of the nation's six major accounting firms, the AICPA has enlisted a slew of lobbyists to make sure accountants who approve a company's annual financial statements don't have to pay out large sums of money when it is their clients, not the accountants, who are at fault. Quarterbacked by Mark Gitenstein, a former chief counsel of the Senate Judiciary Committee and a partner in the D.C. office of Chicago's Mayer, Brown and Platt, the accountants are mobilizing their membership to contact their representatives on the Hill. 'It's a huge piece of the action', says AICPA chief lobbyist John Hunnicutt, whose group also boasts a well-stocked political action committee. 'Virtually 80% of (lawmaker) contact going on is through our membership, large firms and small firms, both.' Working for the Big Six accounting firms, which also have their own Washington representatives, are several prominent lobbyists, including former Rep. Toby Moffett Jr. (D-Conn.), who now has his own lobby shop, Strategic Policy, Inc.; Michael Boland and Peter Madigan of Boland and Madigan, a subsidiary of Cassidy and Associates; and David Johnson of Johnson, Smith, Dover, Kitzmiller & Stewart".

It should be noted in passing that this "accountants relief act" would have been enacted even without the November 1994 sea change, which transferred control of both Houses of the Congress from the Democrats to the Republicans. A principal sponsor of that legislation was Senator Christopher J. Dodd who also served as co-chairman of the Democratic National Comittee.

This legislation was composed in the US Senate Committee on Banking, Housing and Urban Affairs, as S.240, under the aegis of Chairman Alfonse D'Amato; but from all indications, it might well have been orchestrated in the offices of the American Institute of CPAs in Washington and/or Harborside and/or New York. Thus, the Accounting Establishment got all for which it was importuning before the November, 1994, elections; and even more from the 104th Congress which was sworn in January, 1995.

According to the legislative history compiled for the United States Senate ("the legislative history") the principle beneficiaries of the enactment were the accountants; they argued that:

> "Accounting firms particularly have been hard hit by securities litigation. The six largest firms face US$10 billion in 10b-5 claims. Their gross audit-related litigation costs amounted to US$783 million in 1992—more than 14% of their audit revenues for that year. Former SEC Commissioner A.A. Sommer, who heads the Public Oversight Board, the inde-

> pendent body that oversees the accounting profession's self-regulatory efforts, testified that, in view of 'some recent judgments and the amounts being sought in pending cases, it is not beyond the pale to believe, and some responsible people do believe—that one or more major [accounting] firms may ultimately be bankrupted.'"

That was a most cleverly crafted statement.

We know, Al Sommer's "Chicken Little" and foreboding never came to pass. It was clear by the time it was enshrined in the Senate document that there was no such contingency.

I do not question the US$10 billion figure; nonetheless, anyone with an even vicarious awareness of the legal process would know that "claims" mean nothing more than numbers entered into the complaint, they are not even "quick and dirty" or "ball park" numbers.

But the especially disingenuous aspect has to do with the "$783 million" 1992 gross audit-related costs. Note, first, that it is "gross"—presumably before deducting the sums absorbed by the malpractice insurers. Then, too, that hefty figure is presumed to include the premiums paid for the insurance, as well as the in-house counsel costs.

But now, note that 1992 was the year that was identified by the welfare-supplicants; that happened to be the year when Ernst and Young agreed to the US$400 million settlement for their grievous S&L audit failures.

But after all was said and done the Congress of the United States capitulated to the pleadings by the Accounting Establishment—hence the Private Securities Reform Act of 1995, to which I now turn.

For the purposes of this *Critical Perspectives on Accounting* article I will essentially limit myself to a commentary relating to "Critical", "Perspective" (mine) and "Accounting". Accordingly, that which follows is intended as a commentary on the provisions of the enactment which are especially relevant for the accounting profession; thus, I will avoid elaborating on those provisions which are essentially procedural, and are therefore primarily of interest for lawyers.

The Grand Prize—"Separate and Proportionate" Liability

Section 201 of the 1995 Act added a new section, Section 21D, to the 1934 Securities Act so as to supersede the prevailing "joint and several" standard by a "separate and proportionate" standard for assessing damages in private actions brought under the 1934 Act. It was this radical shift which was central to the AICPA's aggressive quest for legislative relief. Pursuant to this new section, should the jury determine that the defendants' liability is US$100 million, for example, the jury would then be directed to determine the percentage of responsibility of each of the defendants "measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff". If then, the auditors percentage is determined to be 10%, their liability would be

US$10 million, except that: if any of the other defendants are insolvent or their shares are otherwise uncollectible, their portion is then reallocated among the "deep pockets", excepting that the primary percentage may not be increased by more than 50% thereof, so that the auditors liability would be increased to US$15 million.

There is also a "small claim" exception for individual plaintiffs with net worth less than US$200,000 and whose recoverable damage exceeds 10% of net worth.

Knowingly Committed a Securities Violation

There is another, especially significant, exception: When it is determined that the auditors "*knowingly* committed a violation of the securities laws", they continue to be subject to the "joint and several" standard. The Congress then proceeded to define the phrase "*knowingly* commits a violation of the securities laws" most circumspectly thus: (A) a covered person knowingly commits a violation of the securities laws with respect to an action that is based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading if;

1. that covered person makes an untrue statement of a material fact, with *actual knowledge* that the representation is false, or omits to state a fact necessary in order to make the statement made not misleading, with *actual knowledge* that, as a result of the omission, one of the material representations of the covered person is false; and
2. persons are likely to reasonably rely on that misrepresentation or omission; and with respect to an action that is based on any conduct that is not described in clause (1), if that covered person engages in that conduct with *actual knowledge* of the facts and circumstances that make the conduct of that covered person a violation of the securities laws. [emphasis supplied]

But then the Act went *Hochfelder* "one better"; thus the late Chief Justice Berger included a pregnant footnote to his *Hochfelder* opinion to wit:

> "The term scienter refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional misconduct for purposes of imposing liability for some act. We need not address here the question whether in some circumstances reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5."

The 1995 Enactment then proceeded to negate that contingency thus: "(B) reckless conduct by a covered person shall not be construed to constitute a *knowing* commission of a violation of the securities laws by that covered person." [emphasis supplied]

In short, only a conspiratorial involvement would continue to subject the auditor to the "joint and several" liability. Again, why this conduct should not invite a criminal indictment escapes me.

It is more than a half century since I heard of this silly tale, and I never even thought of it in any context involving a SEC registrant. This absurdity went as follows: A CPA was requested to audit a company's books; he piled the books on the floor, stepped over them, and then certified, truthfully, of course:

"I went over the books and found nothing wrong".

CPAs as RICOs

Section 107 of the Act excluded from conduct subject to penalties under Racketeer Influenced and Corrupt Organization Act that which would have been actionable as fraud in the purchase or sale of a security as a predicate offense under Civil RICO.

The RICO Statute, 18 US Code Section 1962 (c) which was thus rendered nugatory makes it unlawful: "For any person employed by or associated with [an interstate] enterprise...to *conduct* or *participate*, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity..."

At first blush RICO should be something of an oxymoron when considered regarding independent auditors; after all that four-letter acronym was presumed to relate to organized crime—which ordinarily would not subsume CPAs. As it happened the accounting profession got something of a wake-up call in a March, 1993 decision of the Supreme Court of the United States in *Reves et al.* v. *Ernst* & Young, 507 US 170. That decision which went in favor of the auditors was the final stage of a convoluted legal proceeding involving trials of the facts and successive appeals to the Supreme Court. The plaintiffs were representatives of a class of noteholders of a Cooperative, the Farmer's Cooperative of Arkansas and Oklahoma ("Co-op") for which Arthur Young (now part of Ernst and Young) served as the independent auditors for the years 1981 and 1982.

By way of background, the case went to trial in the United States District Court for the Western District of Arkansas on the state and federal securities fraud claims. The jury found that Arthur Young had committed both state and federal securities fraud, and awarded approximately US$6.1 million in damages. The only part of this extended litigation which is relevant for present purposes is the appeal from a decision of the Appellate court denying the noteholders' claim for RICO damages.

Before proceeding, by way of full disclosure, I was engaged as an accounting expert on behalf of the Co-op in the initial phase of the legal proceedings; I had no involvement in any of the subsequent appellate stages.

The essential facts which follow were culled from the opinions of the Supreme Court, both majority and dissent:

- The Co-op's accountings for the years prior to 1981 were prepared and certified by Gene Kuykendall who was convicted along with the Co-op's former president, Jack White, for their felonious conduct related to the Co-op.
- The Gasohol project was initiated in 1979 by and for Jack White, individually; when it ran into serious financial difficulties it was taken over by the Co-op.
- The dilemma confronting Arthur Young on its 1981 audit was to determine the cost to be assigned as the carrying value for the investment. Had the auditors booked the plant at its 1981 value, it would have been approximately US$1 million; but that would not have produced the optimal balance sheet, accordingly, they determined, on their own initiative, to book the asset at its aggregate cost as though it had been owned by the Co-op from "its inception", i.e. at US$4.5 million.
- Before the Court of Appeals, although Arthur Young disputed Reves' claim that it had been functioning as the Co-op's *de facto* chief financial officer, it did not dispute the District Court's conclusion that Reves had presented evidence showing that Arthur Young had created the Co-op's financial statements and had participated in the creation of condensed financial statements that were handed out each year at the annual meeting of the Co-op. Instead, Arthur Young argued that

  "[e]ven if, as here, the alleged activity goes beyond traditional auditing, it was neither an integral part of the management of the Co-op's affairs nor part of a dominant, active ownership or managerial role".

This brings us to the March 1993 Supreme Court decision:
Mr. Justice Blackmun provided an exegetic analysis of the provisions of the statute and its legislative history and determined, for himself and six of his colleagues in favor of Arthur Young:

> "Examination of the statutory language in the light of pertinent dictionary definitions and the context of Section 1962(c) brings the section's meaning unambiguously into focus. Once it is understood that the word 'conduct' requires some degree of direction, and that the word 'participate' requires some part in that direction, it is clear that one must have some part in directing an enterprise's affairs in order to 'participate, directly or indirectly, in the conduct of such... affairs'".

In his dissent, Justice Souter, on behalf of himself and Justice White asserted:

> "By these actions, Arthur Young took on management responsibilities, for it thereby made assertions about the fixed asset value of White

Flame that were derived, not from information or any figure provided by the Co-op's management, but from its own financial analysis. "By assuming the authority to make key decisions in stating the Co-op's own valuation of its major fixed asset, and by creating financial statements that were the responsibility of the Co-op's management, Arthur Young crossed the line separating 'outside' auditors from 'inside financial managers'".

As my response to the judgment of the Justices:

Viscerally I side with Justice Blackmun and the majority; that is because I find it repugnant to have any of our colleagues required to wear the scarlet letters, "RICO".

Intellectually, I side with Justices Souter and White in the dissent. That is because I recall that the ostensibly independent Certified Public Accountant who participated in the preparation of the condensed financial statements, cropped so as to avoid disclosure of the Gasohol plant loss, also participated prominently at the annual meeting and failed to disclose the sad state of the Co-op's affairs.

Beyond the Reves-AY matter, I believe the 1995 enactment went overboard in its providing that penalties are not to be imposed in any Federal Securities Law involvements. Thus, I can see a circumstance where a "crooked accountant" could team up with "a crooked underwriter", "a crooked lawyer", and "crooked management" to cook up a "crooked" securities fraud involving, say, a South Sea Bubble or Ponzi scheme.

Section 101 Safe Harbor for Forward-Looking Statements

Section 101 establishes a "safe harbor" protecting certain forward-looking statements from liability in private actions under the 1933 and 1934 Acts, and grants the SEC authority to promulgate safe harbor rules under the Investment Company Act of 1940.

The safe harbor provision protects written and oral forward-looking statements that "project, estimate, or describe" future events made by issuers and certain persons retained or acting on behalf of issuers. To be protected, the statement must be accompanied by notice that the information is forward-looking and that actual results may be materially different from such projections, estimates, or descriptions.

The definition of "forward-looking information" is the same as contained in the SEC's present safe harbor rule which includes:

- certain financial items, including projections of revenues, income, earnings, capital expenditures, dividends, and capital structure:
- management's statement of future business plans and objectives;
- certain statements made in required SEC disclosure including management's discussion and analysis and results of operations; and
- any disclosed statement of the assumptions underlying the forward-looking statement. The SEC may expand the definition by rule or regulation.

The safe harbor provisions do not extend to a number of areas here

deemed significant, to wit: (i) included in financial statements prepared in accordance with generally accepted accounting principles; (ii) contained in an initial public offering registration statement; (iii) made in connection with a tender offer; (iv) made in connection with a partnership, limited liability corporation or direct participation program offering; or (v) made in beneficial ownership disclosure statements filed with the SEC under Section 13(d) of the 1934 Act.

The SEC may promulgate rules or regulations to expand the statutory safe harbor by providing additional exemptions from liability. This section also grants the SEC authority to recover damages on behalf of investors injured by reason of violations involving a forwardlooking statement not protected by the safe harbor.

A Crumb for the SEC

As noted earlier, the US Supreme Court in its 1994 decision in the *Central Bank* case aborted the long-standing "aiding and abetting" basis for a securities fraud claim. There was an important move to resurrect that basis; it was only partially successful, in that it was restored for the SEC. Thus section 108 of the Act added a new subsection to the 1934 Securities Act so as to authorize the SEC to bring an action seeking injunctive relief or money penalties against persons who knowingly "aid and abet" primary violators of the securities laws.

The Price—"Title III—Auditor Disclosure of Corporate Fraud"

In order to attract the 67 votes required to override the President's veto (68 votes were garnered), a section designed to require auditors to search for, and if necessary, disclose, fraud was included in the enactment. This took the form of Title III, Section 301 which includes:

> "(a) In General—Each audit required pursuant to this title of the financial statements of an issuer by an independent public accountant shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission
>
> "(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;
>
> "(2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and
>
> "(3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

.... These objectives were accomplished, by the addition of Section 10a of the Securities Act of 1934: requiring independent public accountants to institute certain procedures in connection with their activities. If an accountant learns of an illegal act that may be "consequential" to the company, the accountant must provide this information to the company's management. If management fails to act, and the accountant determines that the illegal act would have a material effect on the issuer's financial statements, the accountant must report the information to the board of directors. If the board fails to notify the Commission within one day, the accountant must notify the Commission the following day. Failure to provide this notification will subject the accountant to civil penalties.

It is that Title III which has induced some angst for our auditor-colleagues; they are, after all, comfortable in serving the role of "cheer leaders" for their clients, as a former SEC Chief Accountant asserted—and now they are being called upon to assume an adversarial role, as "sleuth" or possibly, "even informers". This was noted in a *Wall Street Journal* article (December 24, 1996), "Auditors Are Ending up between A Rock and A Hard Place over Securities Law noting that:

> "The Federal legislation puts auditors in an impossible position," says Mr. John Hughes, a Boston attorney who represents both investors and accountants in accounting malpractice cases. "So far, the AICPA has done nothing to help them because it doesn't want its members to be liable for this detective work." Dan Guy, the AICPA staff member in charge of audit rules, denies this charge. Mr. Guy does say that auditors must detect illegal acts that materially affect a company's financial statements, such as fraud, a requirement already in the AICPA rules."
>
> The AICPA has left standing older rules that could provide auditors with a justification for avoiding increased duties under the new law. AICPA rules state that auditors don't have to hunt for any illegal acts unless they first find a misleading number or omission on a company's financial statements or receive information about misconduct.
>
> But the new law says they must indeed hunt for illegal acts, a spokesman for Senator Wyden notes, "if the profession can't regulate itself, Congress may revisit the new law to make damn sure auditors know what they're supposed to be doing," the spokesman adds.

So what will come from this new directive to truth, beauty and integrity in our corporate culture, and clear and compelling directive to my colleagues in practice to assure the fulfilment of that idyllic standard? My response is that it's all *deja vu*. This cynical response goes back more than a score of years to the enactment of the Foreign Corrupt Practices Act of 1977 ("FCPA"). That enactment was prompted by manifestations of perfidious conduct by persons at the highest levels of Lockheed, Northrop, Gulf Oil and ITT *et al.*

The FCPA was designed to prohibit what President Carter called "ethically repugnant and competitively unnecessary" conduct. Along with

prohibiting companies from engaging in certain corrupt practices with respect to foreign officials, the act amended Section 13(b) of the Securities Exchange Act of 1934 to require reporting companies to make and keep accurate books and records and to establish and maintain a system of internal accounting controls which meet certain objectives.

Surely, this legislation should have given rise to a hosanna from my colleagues in practice; the Congress had given legislative approval to our auditing standards pertaining to internal control. Our corporate clients were told that henceforth their endeavors to mislead us might lead to criminal indictments and even convictions. This was something which many of our auditing colleagues were urging in the wake of corporate Watergate. How did the accounting profession respond to this new congressional mandate?

Sadly, this new cloak of authority and legitimacy for our profession was too heavy for our shoulders. In any event, our colleagues determined to join with corporate managements in resisting the endeavors by the Securities and Exchange Commission to implement the legislation.

The SEC in 1979, in line with what it saw as Congress's intent, proposed that, after December 14 1979, annual reports should contain a statement from management saying the internal controls provided "reasonable assurance" of achieving their objectives, and a year later should contain an auditor's certified opinion on this management statement.

Subsequently, the Commission recanted; it issued a June 6, 1980, "Statement of Management and Internal Accounting Control: Withdrawal of Proposed Rules". This move was motivated in part, by the SEC's "determination that the private sector initiatives... have been significant and should be allowed to continue".

The Commission said it will be studying the progress of these "private initiatives" over a three-year period, and then will give further consideration to any required rule making.

Well, it is now more than a score of years since that enactment, and only 18 years since the SEC was going to study the progress in the private sector. So if the "past be prologue" we should expect to revisit the issue in 2017 or thereabouts.

And now the Congress has, in fact, mandated that the SEC move with only deliberate speed in implementing the 1995 mandate of Title III; from the Senate's legislative history of the 1995 enactment:

> "The [Senate] Committee does not intend to affect the Commission's authority in areas not specifically addressed by this provision. The Committee expects that the SEC will continue its long-standing practice of looking to the private sector to set and to improve auditing standards. The SEC should not act to 'modify' or 'supplement' generally accepted auditing standards for SEC registrants until after it has determined that the private sector is unable or unwilling to do so on a timely basis. The Committee intends for the SEC to have discretion, however, to determine the appropriateness and timeliness of the private sector response. The SEC should act promptly if required by the public interest or for the protection of investors."

In February 1997, the AICPA's Auditing Standards Board issued SAS 82, "Consideration of Fraud in a Financial Statement Audit". It might have been expected that that statement, in view of the timing and circumstances, would have sounded a clarion call for the auditors to comply with the objectives of Title III.

The statement refers to the auditor's responsibility to "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud". We are then informed that SAS 82 is intended to "provide guidance to auditors in fulfilling that responsibility, as it relates to fraud... " In sum, rather than as the directive called for by Title III to move aggressively to ferret out fraud, the SAS is essentially an exercise in "sensitivity training", i.e. to improve the auditors' olfactory sense so as to smell a Stygian Swamp should it exist in a client's situation, unless it is how to step gingerly should there be an Augean Stable.

The SAS does however, pay its respects to the 1995 enactment by a footnote to paragraph 40 which relates to the possibility of communicating the existence of fraud to parties "outside the entity" including "reports that may be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in Section 10A(b)1 of the Securities Exchange Act of 1934) relating to an illegal act that has a material effect on the financial statements..."

On 12 March 1997, the SEC published its Rule 10-a to Regulation S-X, to give effect to the Title III enactment. That rule did nothing more than track the provisions of Section 301 excepting that it did add the addresses to which the relevant notices were to be directed.

That there is just such an urgent and compelling need for the intensified dedication to the independent audit responsibility on the part of our Accounting Pentagon, i.e. the Big Five, is vividly demonstrated by an item from Dow Jones on July 14, 1998, as this essay is going through some final editing (though it is likely that there would be corresponding horror stories whenever the final editing would be in process):

That item (ellipses omitted) follows:

> "Cendant Corporation (NYSE:CD) announced today it believes that accounting irregularities at the former CUC International ("CUC") were greater than those initially discovered by Cendant management in April of this year. "We have now received evidence that for at least the last 3 years the financial results of the former CUC reflected a continuing program of false entries which misrepresented the financial performance and condition of that company," said Michael P. Monaco, Vice Chairman and Chief Financial Officer of Cendant.
>
> "These accounting practices were widespread and systemic and affected the accounting records of all the major business units of CUC," he continued. "Information recently reported to us by independent investigators from Arthur Andersen, confirmed by work done by Deloitte & Touche, led us to increase our estimate of these accounting irregularities, which the Company and its auditors define as accounting errors made with an intent to deceive.

"Our previous estimate of the irregularities, developed in April, relied heavily on the mid-level CUC managers who helped us discover this problem." said Monaco. "The newly discovered irregularities involve practices that were uncovered by the subsequent investigation."

In addition, Cendant's investigation now confirms that accounting irregularities existed in CUC's financial statements in years prior to 1997 and that in addition to 1997, 1996, and 1995 results will be restated to correct irregularities.

"Cendant's probe of CUC's financial records, while not finished, is substantially complete," Monaco continued. "Arthur Andersen is expected to provide a report to our Audit Committee in two weeks, and Cendant expects to issue full restated and audited historical financial statements in early August". Deloitte & Touche act as principal independent accountants to Cendant and has replaced Ernst&Young as the auditor of these historical statements.

Arthur Andersen's forensic audit was commissioned by Willkie Farr & Gallagher as part of its overall investigation of the accounting irregularities on behalf of the Audit Committee of the Cendant Board. The Audit Committee's report of that investigation should be completed in August.

Cendant also continues to cooperate with the Securities and Exchange Commission and the United States Attorney's office in Newark in their investigations of these matters

"The combined efforts of Cendant, Arthur Andersen and Deloitte & Touche have delivered a level of accounting scrutiny several orders of magnitude greater than that afforded by a normal audit process," said Monaco. "We are of course outraged by these most recent findings. However, the length, breadth and depth of the investigation ordered by our Board and management have now proven its worth by uncovering additional systemic irregularities beyond those initially discovered and immediately disclosed by Cendant management. We believe our thoroughness will benefit our shareholders and help restore confidence in our Company's prospects and financial results".

The Accounting Irregularities:

- Irregular charges against merger reserves. Operating results at the former CUC business units were artificially boosted by recording fictitious revenues through inappropriately reversing restructuring charge liabilities to revenues. Many other irregularities were also generated by inappropriate use of these reserves.
- False coding of services sold to customers. Significant revenues from members purchasing long-term benefits were intentionally misclassified in accounting records as revenue from shorter-term

products. The falsely recorded revenues generated higher levels of immediately recognized revenues and profits for CUC.

- Delayed recognition of cancellation of memberships and "charge-backs" (a charge-back is a rejection by a credit card-issuing bank of a charge to a member's credit card account). In addition to overstating revenues, these delayed charges caused CUC's cash and working capital accounts to be overstated.
- Quarterly recording of fictitious revenues. Large amounts of accounts receivable entries made in the first three quarters of 1997 were fabricated, had no associated clients or customers and no associated sale of services. This practice also occurred in 1996 and 1995.

The Accounting Errors:

- Cendant, working with Deloitte & Touche, has also discovered accounting errors in CUC's financial records that are not classified as accounting irregularities. These accounting errors include inappropriate useful lives for certain intangible assets, delayed recognition of insurance claims, and use of accounting policies that do not conform to generally accepted accounting principles.

A July 22, 1998, *Wall Street Journal* (p. A3) captioned "Cendant's Former Auditor suggests it was misled" informs us that.... "Ernst & Young sought to distance itself from fraud disclosures at the franchising and marketing concern, suggesting for the first time that its auditors were misled by company management".

The article concluded with the following observation: "Even so, accounting watchdogs say Ernst should have caught CUC's accounting problems. Even if they can't see the swamp, they should be able to smell it because the amounts are so gigantic. It's not a case of walking away with a petty cash box, said accounting expert Abraham J. Briloff. 'If they cannot detect an enormous fraud of this nature, then pray tell what is the role of the independent auditor?'"

So it is that Arthur Andersen has been thus identified as the gallant white knight committed to the ferreting out and destroying the forces of evil and perversity. However, I cannot avoid recalling that it is that very firm which has all too frequently been identified as allied with those very same forces.

Is this yet another case where a fox has been sent in to clean out the hen house?

During the hiatus between the submission of the manuscript (July, 1998) and the receipt of the proofs (January 1999) there were two developments which are noteworthy in this context.

First, in August Arthur Andersen submitted its report as Cendant's "Certified Independent Forensic Auditor" with the following as its opening gambit:

> Throughout the Restatement Period (1995–1997) numerous accounting irregularities and improper accounting practices occurred which had the

> effect of inflating revenues or decreasing expenses. The irregularities were pervasive.
>
> The information that has been obtained indicates that the purpose of many of the irregularities was at least to conform CUC's publicly-reported results to Wall Street's earnings expectations. During the Restatement Period, operating income was improperly inflated by an aggregate of approximately $500 million before taxes, which represents one-third of the total operating income reported by CUC.

Then, *mirabile dictu*! During October it was disclosed that "Chain Saw" Albert J. Dunlap's extraordinary earnings accomplishments at Sunbeam Corp. were attributable more to some "heavy lifting" in the accounting department than with his restructuring capabilities. Thus, from a *Barron's* article dated October 26:

> Sunbeam's long-awaited restatement of financial results under deposed chairman Albert J. Dunlap was disclosed last week after four months' work by two accounting firms. It cuts the home-appliance company's reported 1997 profit by nearly two-thirds, to $38.3 million or 44 cents a share, from the previously reported $109.4 million or $1.25.
>
> The restatement also boosts this year's first-quarter loss to $54.1 million or 63 cents a diluted share from the earlier $44.6 million or 52 cents.

And then, from a December 1 *Wall Street Journal* article:

> Delray Beach, Fla—Sunbeam Corp. dismissed Arthur Andersen LLP as its independent auditor and named Deloitte & Touche LLP to audit 1998 results.
>
> The struggling appliance maker recently restated its financial results for 1996, 1997 and the first quarter of 1998—periods during which Albert J. Dunlap presided as Chairman and Arthur Andersen served as independent auditor.
>
> Industry observers said the move could pave the way for Sunbeam to file suit against the New York Accounting firm, alleging auditing deficiencies.

And so the "White Knight" in the Cendant saga became the "Black Knight" in the Sunbeam drama; Deloitte & Touche, the Cendant "Grey Knight" turns up as the Sunbeam "White Knight."

Coda

In the wake of the 1995 enactment class action litigation involving securities moved to the courts of the various states where the plaintiffs

still enjoyed their traditional prerogatives—much to the dismay of the accounting establishment and their stalwart supporters; whereupon they moved to the Congress to importune for additional relief.

The Congress moved to accommodate these pleadings from their constituents with legislation dubbed "Securities Litigation Uniform Standards Act," to establish uniform regulations across state lines, consistent with those in the 1995 enactment, thereby making it more difficult to file these securities suits in state courts as well.

There is an ironic incongruity in all this. Thus, the major thrust in recent years by the Congress, the Accounting Establishment, *et al.* was towards deregulation, getting the Federal government "off the backs" of private enterprise, inducing a further devolution of power from Washington to the State Capitols. However, as Emerson informed us, "a foolish consistency is the hobgoblin of petty minds"—and no one should accuse the Congress or the Accounting Establishment of having such minds, especially where their deep-pocket constituencies are involved.

This legislation was enacted on November 3, 1998 as the "Securities Litigation Uniform Standards Act of 1998."

EXHIBIT B

Abraham J. Briloff, Ph.D., CPA
Emanuel Saxe Distinguished Professor Emeritus

Outline of Remarks

Securities and Exchange Commission Hearings

September 20, 2000

Re: Comment File No. S7-13-00

1. Historical Perspective
   a. Effectiveness of Accounting Communication, (Praeger, 1967)
   b. Letter to Senator Charles Schumer, July 31, 2000 relating to the Controversey and various related materials
2. The Hubris of the Accounting Establishment
   a. "Prove the Negative"
   b. Would we accept a corresponding challenge in:
      1. The Executive, Legislative or Judiciary Branches of our Government?
      2. For tire manufacturing, healthcare, food and drugs, journalism, . . ., . . .
         industries? (fill in the blanks)

3. The "Perception" vs. "In Fact" Mantra

   a. A case of Denial and/or Hyperbole and/or Disingenuousness and/or Mendacity

   b. Some cases of "In Fact"

      1. From my Unaccountable Accounting (Harper & Row, 1972) Westec, "Back Office Mess in Wall Street"

      2. More recent examples Arkansas and Oklahoma

         - Farmers Cooperative (leading to RICO proceedings before the U.S. Supreme Court case involving Arthur Young)
         - Disney Accountings as discussed in my Barron's article (March 23, 1998)
         - I sense that the conflict existed in the CUC (Cendant) controversies

4. Quo Vadis?

(In descending order of preference)

a. Absolute Divestiture, i.e., No "Strategic" or Other Entangling Alliances

And then demand that the profession of certified public accountancy re-dedicate itself to the independent audit as surrogates in behalf of all stakeholders. This is the covenant which we are presumed to have undertaken with society – let us fulfill it without let or hindrance.

Such a rededication to the CPA as a professional should put an end to our quest for an XYZ license.

Further, the renaissance of the independent audit as a vital social responsibility should prove salutary for relevant research and teaching of accountancy qua accountancy in the groves of aademe.

b. Assure Absolute Transparency:

- The independent audit committees should be required to disclose to the stockholders, et. al., all arrangements with the independent auditors and the related fee arrangements. (It may also be appropriate for the committee to report to the shareholders, et. al. regarding the sensitive areas of discussion called for by the Kirk Report)
- Ban any agreements of confidentiality in the wake of judgments as settlements involving auditors' liability

c. Abort the requirement for an audit by independent (sic!) certified public accountants and proclaim "CAVEAT EMPTOR!" (Here my "accountancy manifesto for the Third Millennium " (Accounting Today, March 13 – April 2, 2000) would be relevant.

PRAEGER SPECIAL STUDIES IN
U.S. ECONOMIC AND SOCIAL DEVELOPMENT

The Effectiveness of Accounting Communication

Abraham J. Briloff

Foreword by
Justice William O. Douglas

FREDERICK A. PRAEGER, Publishers
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Foreword

The Effectiveness of Accounting Communication should have an important and salutary effect on the practitioners of accountancy. Abraham J. Briloff has identified the underlying questions which are serious, even critical. They take me back to the days when corporation finance was my preoccupation and the teaching of accountancy a hobby. Of the questions posed by this book, the most fundamental is the accurate and true determination of the economic facts of corporate operations, and the interpretation, dissemination, and fair expression of such data to those who are entitled to know. The inability to determine the persons in interest to whom the attesting accountant holds himself to be responsible is alone destined to contribute to the deterioration of confidence in the accountant's product.

Looking back and beyond the present crises in accounting practice, this work searches for a definition of the true responsibilities of the auditor in terms of the economic society in which he practices. About a third of a century ago, Gardiner C. Means described the changes in the fundamental character of the "Modern Corporation" brought about through the growth of the corporate complex. This development has since been characterized by Adolf A. Berle as a "Power Without Property" dichotomy. It is in this context that the accounting profession must search for its ultimate identity. Unless it really comes to grips with these economic developments it will not be able to fulfill the role which is so vital to our society.

Nearly thirty years ago, while Chairman of the Securities and Exchange Commission, I advocated a system of paid directors to harmonize the various elements of public interest which converge in the modern corporation. I then observed that while "these elements may superficially appear to conflict, the fundamental interests of all social groups are identical over the long term." While the corporate officer should be expected to recog-

nize these principles, he may be too close to his work to look beyond its immediate necessities. "But the paid director," I noted, "need not be afflicted with such nearsightedness. It would indeed be one of the defects which he would be paid not to have."

Mr. Briloff seeks to vest the independent auditor with a pervasive obligation—one which extends beyond his parochial relationship to his client per se, and to all those entitled to have access to the full and fair disclosure of the facts of corporate activity. This, then, is the logical extension to the independent auditor of the role which I suggested for the "paid director." To that end, Mr. Briloff urges his colleagues to parallel the historian in the ways in which he develops his commitment and pursues his "call," and to develop a philosophy going beyond the all too prevalent "vulgar pragmatism."

The author demands an understandably high price of the attesting accountant, who is preparing himself to fulfill this essential role. He expects him to undergo a "ritualistic purging" and to forego the rewards which may be derived from the rendering of management services and the other "peripheral services" which he describes.

The burdens which Mr. Briloff puts upon the profession are substantial; but, as he demonstrates, our economic society is in urgent need of this service. If the accounting profession does not respond effectively to the challenges presented, there may be little alternative but to have possibly a new profession fill the breach.

The functioning of our capitalistic society is rooted in confidence in those to whom power is delegated. That requires a functioning system of checks and balances; and that in turn demands the effectiveness of communication between and among the various elements in the society and system. In that communication the accountant should play a crucial role.

WILLIAM O. DOUGLAS

Old Myths and New Realities in Accountancy

Abraham J. Briloff

THE title theme for this paper is derived from the opening gambit of Senator Fulbright's speech delivered to the Senate of the United States early in 1964, before he became the center of current controversy, which begins:

> There is an inevitable divergence, attributable to the imperfections of the human mind, between the world as it is and the world as men perceive it. As long as our perceptions are reasonably close to objective reality, it is possible for us to act upon our problems in a rational and appropriate manner. But when our perceptions fail to keep pace with events, when we refuse to believe something because it displeases or frightens us, or is simply startlingly unfamiliar, then the gap between fact and perception becomes a chasm, and action becomes irrelevant and irrational.[1]

So began Senator Fulbright's address now known as "Old Myths and New Realities." What old myths in accountancy prevent us from seeing reality, thus producing gaps between perception and fact, so that our action becomes irrelevant and irrational?

This paper will consider three such divergencies. The first is what I describe as the "Gap in GAAP," whereby our special idiom, generally accepted accounting principles, fails to serve as an effective medium for common understanding. This linguistic gap precludes the comprehension of the message being communicated to those who require this understanding as an incident to their decision making in a great many areas of our economic existence. Correspondingly, this state of Babel prevents management from discharging its responsibility to account regarding its stewardship to those who have delegated the control over the entity's property.

The second such contrast between perception and fact can be discerned in the presuppositions on the part of even the sophisticated members of the financial community regarding the nature and extent of the auditor's involvement in the determination of the statements of financial condition and operations—statements which the auditor represents only as being fairly presented, but which the community presumes to be fair in fact.

The third such dichotomy revolves about the profession's presumption that the financial community knows of our involvement in a whole circle (or is it circumference?) of peripheral services to manage-

[1] J. W. Fulbright, *Old Myths and New Realities* (Random House: 1964), p. 3.

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TABLE 1
SUMMARY OF RESPONDENTS

The Financial Community		*The Accounting Profession*	
vestment analysts with advisory services, and ancial writers	15	Practitioners of accountancy	
		With the "Big-8" firms	17
		With other firms	14
vestment analysts with brokerage firms	11	Total practitioners	31
vestment analysts with banks	13	Professors of accountancy	21
vestment analysts with mutual funds, insurance mpanies, and associations	18	Others, including financial executives of publicly owned corporations, executive personnel with the American Institute of CPAs	12
hers, including officials with governmental agen- s, lawyers engaged in securities underwriting	15		
Total	72	Total	64

ent and that this community concurs in he profession's view that this involvement oes not adversely affect the independence f the auditor.

As will become apparent from the dis- ussion that follows, this crisis in commu- ications exists not only between the pro- ession and the users of the financial state- ents (so as to produce a crisis in confi- ence and integrity) but also extends to a ailure on the part of the various segments or sectors of the profession to reach a com- mon understanding among themselves.

The Research Leading to this Analysis

First, let me describe the primary research study which produced the data in which my subsequent discussion is rooted. For the purposes of this study a questionnaire composed of three categories of questions was developed, as follows.

The "A" series of questions (consisting of about 50 critical questions) was general in nature and sought to determine (1) the respondents' views regarding the present-day economic environment and (2) their understanding of, and degree of satisfaction with, the services rendered by accounting firms for the corporate entities whose statements are then the subject of independent audit by such firms.

The "B" series of questions sought to determine (1) the respondents' satisfaction with the way in which our underlying theory evolves, and (2) their views on the extent to which this theory is understood and accepted. (This series also called for some 50 critical responses.)

The "C" series of questions set forth various business transactions and events in those areas which are now considered to be the subject of major reappraisal by the profession (e.g., Lifo, long-term leases, business combinations, depreciation, and pension cost). This series, calling for 100 responses, determined whether the users of the financial statements shared the awareness and concern of the statement-preparers regarding these problem areas.

The research reported and analyzed the responses received from 136 respondents, of whom 72 were from the financial community and the remaining 64 were from the accounting profession; these respondents are subdivided into their special identification within the community or the profession, respectively, in Table 1 above.

I believe it more than a conceit to say that the quality of the respondents who were willing to give from three to five hours for responding to the questionnaire calling for some 200 critical responses was gratifying beyond the dreams of a researcher's avarice. To justify this felicity it might

first be noted that seven of the respondents from the profession are included in the Cumulative List of Officers which introduces the 50th Anniversary Membership Roster of the American Accounting Association. And as to the respondents from the financial community, fully 68% of them are members of the Financial Analysts Federation; 14% possess the degree of Chartered Financial Analyst. (That one out of seven is a CFA can be seen to be an extraordinarily high ratio when we realize that the degree-granting institute was incorporated only about a year preceding the time of the research.)

Consideration of the Gap in GAAP

Returning to the mainstream of this paper, the demonstration of the prevalence of old myths in the face of new realities, I shall consider the first such polarization, the one which I consider to be the basic roadblock to effective communications, namely the "gap in GAAP" (generally accepted accounting principles).

In this specific connection, the Series "C" questions were intended to determine whether the standards set forth by John L. Carey in 1962 (*The Accounting Profession: Where Is It Headed?* page 54) as "the keys to successful data communication" are being met. These "keys" included: (1) The issuer and user of economic data must have an understanding as to standards for measurement and summarization. (2) The communication must be intelligible to the user.

While the Long-Range Objectives Committee of the Institute determined, after considering these keys, that "the attest function is being discharged, on a constantly widening scale," my study demonstrated that this self-approbation is not warranted. Instead, the responses showed that there are major divergencies ("major" being presumed to mean a divergence "in excess of 20 percentage points"[2]) in the understanding of the accounting for the following:

Extraordinary income
Long-term leases
Lifo inventories
Accounting for oil and gas operations
Pooling of interests
Associated entities
Accounting for pension cost
Depreciation accounting
Accounting for research and development cost

Other evidences that the gap in GAAP had widened into a chasm were also discerned from the responses to the question where the respondents were asked: "For the purpose of this question assume that . . . a body of generally accepted accounting principles does exist. In your opinion . . . to which of the several groups described below are these principles reasonably well known?"

The respondents indicated that they believed the body of GAAP to be reasonably well known to various "user-groups" as tabulated in Table 2.

It might well have been expected that accountants with the SEC would be presumed to be thus knowledgeable; interestingly, these accountants themselves have, at times, been far less pretentious. So it is that two years ago the Chairman of the Securities and Exchange Commission, William Cary, and its Chief Accountant, Andrew Barr, were asked by Congressman Staggers, who was chairman of the subcommittee considering further investor protection, to file with his committee a statement of the areas of accounting where alternative practices could produce materially different results—all under the umbrella of GAAP—and also to give their conclusions as to the significance of each area. The response of Messrs. Cary and Barr was that while they could supply the

[2] This means that the percentage from the financial community responding affirmatively varied by more than 20 percentage points from the corresponding percentage for the accounting profession.

TABLE 2

RESPONDENTS' VIEWS AS TO THE KNOWLEDGE OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES BY VARIOUS USER GROUPS

	From the Financial Community		*From the Accounting Profession*	
	Yes	*No*	*Yes*	*No*
Chartered financial analysts	71%	20%	55%	28%
Investment advisers generally	40	42	17	67
Economists generally	24	50	5	83
Government personnel with regulatory agencies	40	38	28	59
Individual investors generally	4	89	3	95
"Customers men" with stock brokerage firms	3	83	2	89
Accountants with the SEC	93	3	94	6

Committee with the examples, the cases, the situations, where there are divergencies, they could not "promise to do a very satisfactory job on the second phase" of measuring the impact of these divergencies.[3]

Should it, therefore, have come as a surprise when J. Howard Laeri, Vice Chairman of the First National City Bank, speaking to credit grantors, asserted that: "Altogether, there is a considerable audit gap, which unfortunately will not be filled by verbal reform. . . . The audit gap must be filled, nevertheless. In his book on the accuracy of economic statistics, Oskar Morgenstern wrote that 'the investor should be the first to insist on the introduction of a modern spirit into this sadly stagnant field.' "[4]

This criticism came especially hard for the profession since we have been told that we should recognize a shift in the "vital center" of the audience for our financial statement communication from one which is broad-based, from one rooted in the people generally, to an elite comprised of the professional analysts, etc. The recognition of such a shift has been urged by Mautz and Sharaf[5] and Corliss Anderson[6] among others. When, therefore, someone in this very hierarchy expressed disapprobation in no uncertain terms, his address was met with an editorial response in the March, 1966, issue of *The Journal of Accountancy*, which concluded with the lament of an unrequited lover, "But why should you kick me down stairs?"[7]

So it is that we are confronted on the one hand with a series of indictments, expressed or implied, from knowledgeable persons outside the profession—while on the other we are told, let's move with only deliberate speed, let's patch up here and there, let's have another inventory and some more recapitulations of alternatives, issue some additional opinions (sometimes conflicting and contradictory), frequently phrased in terms fitting for an oracle so that one can derive whatever counsel one is seeking. All this, mind you, when even the Chief Accountant for the SEC is constrained to demur in a request that he evaluate the significance of alternative accounting practices.

The Communications Gap Regarding the Auditor's Responsibility

So much for the first of these divergen-

[3] Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, 88th Congress, 1st and 2nd Sessions, on HR 6789, HR 6793, P 1642, p. 1298.

[4] "The Audit Gap," an address given before the *ABA Credit Policy Committee*, New York City, February 1, 1966.

[5] R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing* (American Accounting Association, 1961), p. 19.

[6] Corliss D. Anderson, *Corporate Reporting for the Professional Investor* (The Financial Analysts Federation, Auburndale, Mass., 1962), Foreword.

[7] At p. 32.

TABLE 3
RESPONDENTS' VIEWS REGARDING MEANING OF CLAUSE "PRESENT FAIRLY . . ."

	From the Financial Community	From the Accounting Profession
The clause "present fairly . . . in conformity with GAAP" means that in the auditor's opinion:		
The statements are both fair and in accordance with GAAP..........	44	34
The statements are fair because they are in accordance with GAAP....	22	30
The statements are fair only to the extent that GAAP is fair.........	28	20
None of the foregoing..	6	16

cies, that of the disparity between the word as it is meant and its meaning on hearing, and turn to the second of the gaps selected: that of the divergence between the presumptions regarding the auditor's role as held by the financial community and the role as we know it to be.

Of course, the report of the "Seidman Committee"[8] probing the functioning of the Accounting Principles Board, promulgated in 1965, alluded to this problem when it asked (without answering) the meaning of the critical words in our certificate which assert that the statements are "presented fairly in accordance with generally accepted accounting principles." The questions which that committee asked are identical with those directed to the respondents by my questionnaire, with the results shown in Table 3 above.

The data in Table 3 demonstrate that neither the statement-preparers nor statement-users can develop anything approaching a consensus as to whether the key clause of the auditor's certificate, the very hallmark of his professional labors, means that (1) the statements are *both* fair and in accordance with GAAP; (2) they are fair *because* they are in accordance with GAAP; (3) they are fair *only to the extent* that GAAP is fair. As of the time of this writing the APB has not, to my knowledge, responded to this challenge advanced by the Seidman report.

Let us move from the general to the specific to probe the responsibility which the auditor accepts as an incident to his attest function. We especially explore the chasm which prevails between the statement-user and statement-preparer in this connection.

We, of course, know full well that "the accounts of a company are primarily the responsibility of management."[9] This premise and the implications thereof are pointed up dramatically by Dwight Ladd.[10] Similarly, a partner of one of the major accounting firms observed that "the auditor is not required to state that the principles followed were proper or that, in his opinion, the financial statements give a fair presentation . . . it is possible that the individual auditor may actually believe that the statements are not fairly presented."[11] Herbert E. Miller[12] and Leonard Spacek[13] have also had occasion to derogate the present arrangement for statement responsibility, or rather the failure to fix such responsibility.

[8] *Report of Special Committee on Opinions of the Accounting Principles Board*, Presented to Council of the American Institute of Certified Public Accountants, Spring 1965, p. 14.

[9] *Accounting Research and Terminology Bulletins, Final Edition* (American Institute of Certified Public Accountants, 1961), p. 10.

[10] Dwight R. Ladd, *Contemporary Corporate Accounting and the Public* (Richard D. Irwin, Inc., 1963), pp. 164–5.

[11] John L. Hennessy, "Unrealities in Accounting Reporting" in *Proceedings of the Eighth Annual Institute of Accounting*, University of Colorado, Boulder, 1961, p. 12.

[12] Herbert E. Miller, "Audited Statements—Are they Really Management's," *The Journal of Accountancy*, October 1964, p. 46.

[13] Leonard Spacek, "Are Double Standards Good Enough for Investors but Unacceptable to the Securities Industry?", speech delivered September 30, 1964, before The New York Society of Security Analysts, New York City.

TABLE 4

RESPONDENTS' VIEWS OF PRESUMED ACTION OF INDEPENDENT AUDITOR IN THE EVENT THAT ALTERNATIVE PRINCIPLES MAY APPLY

	Percentage Distribution of Responses				
	Accounting Profession Category				
	Practitioners Big-8 Firms	*Other*	*Professors*	*Entire Category*	*Financial Community Category*
The Auditor Will *Presumably*:					
(a) Take exception	6%	7%	24%	17%	22%
(b) Qualify opinion	18	43	24	23	46
(c) Apply his own selection	0	0	0	0	1
(d) Sub-total	24	50	48	40	69
(e) Describe the alternative but permit management's determination to prevail	24	14	14	22	25
(f) Total	48%	64%	62%	62%	94%
The Auditor *Should*:					
(a) Take exception	12%	14%	24%	22%	35%
(b) Qualify opinion	24	36	43	28	38
(c) Apply his own selection	0	.0	5	5	11
(d) Sub-total	36	50	72	55	84
(e) Describe the alternative but permit management's determination to prevail	18	29	10	19	13
(f) Total	54%	79%	82%	74%	97%

Especially informative in this connection are the data derived from the question of my study which asked the respondents what course of action they believed the independent auditor would follow where "management has selected a particular principle to apply, but the independent auditor considers another . . . principle to be preferable." The responses are summarized in Table 4 above.

As is apparent from Table 4, major confusion is evident on the part of the financial community and even on the part of certain sectors of the profession. Thus, we find that fully 69% of the financial community believed that the auditor would either take an exception or qualify his opinion while another 25% believed that the auditor would describe the alternative but otherwise permit management's determination to prevail. So it is that 94% of these respondents believed that the auditor would do something overt where he believed some other principle to be preferable.

Within the profession itself, 24% of the "Big-8" respondents believed that the auditor would either take an exception or qualify his opinion; another 24% believed that a description of the alternative would suffice. Practitioners with other firms and professors were correspondingly deluded to a far greater extent than our "Big-8" brethren, as is shown by the fact that about one half of each of these groups opted for the "exception-qualification" alternatives, and another 14% in each group presumed that at the least a description of the alternative would be set forth.

Clearly, then, almost all of the statement-users were indulging themselves in an illusion; and, in fact, significant numbers of our colleagues were correspondingly deluded. We know, of course, that the most appropriate, if not the only appropriate, practice under these circumstances would be to give the client "a clean certificate."

It might well be anticipated that just

such a statement of alternative principles is directed by the October 1964 resolution of Council of the Institute[14] that became effective beginning with 1966; however, we also know that this directed disclosure of alternatives first presumes that the APB has promulgated an Opinion on the subject and that it is a definitive, unitary principle, rather than having either stated or adopted a set of alternatives, or stated a principle only with equivocation, as seems to be the present pattern of the Board. So it is that as long as management has adopted a principle contained in the inventory of alternatives promulgated by APB, we know that even today the auditor is constrained to accept the managerial determinations and that we would neither take exception nor qualify nor even state the other options which we, as the auditor, might otherwise prefer.

One might react to this disparity between myth and reality by asserting that this is indeed a regrettable state of affairs, but that it is not our doing. In my view we cannot exculpate ourselves in this fashion; a profession with our third-party responsibility should be required to make abundantly clear, and in no uncertain terms, just what we are doing so that users would not experience the shock of recognition when they become aware of the facts of life as we really know them to be. Instead, it is principally when we are called to account in a court proceeding growing out of some *cause célèbre* that we are desirous of "setting the record straight." At other times we are pleased to run with the hare and hunt with the hounds; to accept our fees as the searchers for truth regarding the corporate entity and yet to act on the assumption (to switch metaphors) that we can lay the basket on management's doorstep if we get into difficulties.

If now Jeremiah might become a Cassandra, it may yet come to pass that our profession will be severely jolted by one or another of the controversies which are presently in the courts. It is not inconceivable that some court may brush aside the niceties to be found in the established catechism and determine that the process of protecting the unsophisticated shareholder requires that the popular view of "who's responsible for financial statements" be deemed to be the standard of performance and accountability, especially where it could be demonstrated that the profession recognized the prevalence of such a pervasive myth. Cassandra is emboldened in this prophecy by the overtones and buzzing in the recent decision of the Supreme Court in the case of the illiterate seamstress, Dora Surowitz. It will be interesting to observe whether the unlettered seamstress has, in fact, introduced something of an unraveling thread for Conrad Hilton, *et al.*

The Communications Gap Stemming from Management Services

We turn next to the third of the areas of our professional problems—the proliferation of accounting services being rendered by firms for the same corporate entities which are then the subject of the same firms' independent attest function. These extended services are generally subsumed under the heading of "management services."

We are all, of course, entirely familar with the established position regarding these services. The Institute's Council, in 1961, stated it to be "an objective of the Institute . . . to encourage all CPA's to perform the entire range of management services consistent with their professional competence, ethical standards, and respon-

[14] American Institute of Certified Public Accountants, "Disclosure of Departures from Opinions of Accounting Principles Board," A Special Bulletin, The Institute, New York, October, 1964.

sibility."[15] In their Opinion No. 12 the Institute's Committee on Professional Ethics determined that "there is no ethical reason why a member or associate may not properly perform professional services . . . in the [area of] management advisory services, and at the same time serve the same client as independent auditor. . . ." This followed from the fact that the committee had determined that the rendering of these peripheral services would not "suggest to a reasonable observer a conflict of interest."[16]

And when someone expresses some misgiving as to the wisdom of this encouragement to CPAs to perform the entire range of management services, as did Professor Joseph E. Lane, for example, in a letter to the editor of *The Journal of Accountancy* (February 1964) suggesting that "this problem deserves further attention," he was met with a peremptory Editor's Note telling him, in brief, that the opinion of the Committee on Ethics and the Resolution of Council should have satisfied his desire for further attention.[17] That the reply did not put to rest the sense of concern, felt within the academic sector of our profession at least, will become clear presently. First let us see how my research questionnaire directed itself to this problem.

In this connection, the questionnaire first elicited the respondents' evaluation as to whether the performance of management services by CPAs in situations where they will also be fulfilling the independent audit function would prove salutary, inimical, or neutral to the auditor's opinion. The respondents were then asked to indicate whether this duality of functions by CPAs was compatible with the auditor's traditions and with his independence, and whether they believed such a dual involvement should be encouraged and extended. The results from these questions appear in Table 5.

As is evident from Table 5, 53% of the users thought these peripheral services would *detract* from the significance of the auditor's opinion, while 17% thought it would be enhanced; 18% indicated that it would have no important effect. Replies from the accounting profession show that 22% felt that these services would detract, while 69% indicated they would not have an important effect. What may also be interesting here is that while not a single respondent from the "Big-8" firms believed that such services would detract, 36% of respondents from other firms and 29% of the professors indicated that they believed such services would have a deleterious effect on the auditor's opinion.

Confirming the financial community's disenchantment, or at least its major misgiving, we find that 49% of the users felt that such a duality of services was incompatible with our traditions; 58% felt that it was incompatible with our independence; 54% asserted that the duality "should be discouraged and restricted." On the other hand, 22% of the professional accountants indicated uniformly that the nexus of services was incompatible with our traditions and with our independence, and should, accordingly, be restricted. Consistent with what I have noted above, there are indications of disagreement among the several groups comprising our profession: thus, while 88% of the "Big-8" respondents believed such a multiplicity of services to be consistent with our traditions only 50% of the other practitioners and 67% of the professors were so inclined. Similarly, while not a single respondent from the "Big-8" firms believed this dual involvement to be incompatible with the auditor's independence, 29% of the other

[15] Resolution by the Council of the American Institute of Certified Public Accountants, adopted April, 1961.
[16] American Institute of Certified Public Accountants, Committee on Professional Ethics, Opinion No. 12, "Independence," 1963.
[17] At p. 30.

TABLE 5

RESPONDENTS' VIEWS OF MANAGEMENT AND TAX ADVISORY SERVICES BY CPAs PERFORMING THE INDEPENDENT AUDIT FUNCTION

	Percentage Distribution of Responses				
	Accounting Profession Caetgory				
	Practitioners Big-8 Firms	*Other*	*Professors*	*Entire Category*	*Financial Community Category*
A. In your opinion, the rendering of management services by CPAs in situations where they will also be fulfilling the independent audit function will:					
(a) Enhance the significance of the auditor's opinion...	12%	7%	5%	8%	17%
(b) Detract from the significance of this opinion......	0	36	29	22	53
(c) Have no important effect on the significance of this opinion......	88	57	67	69	18
B. In your opinion, the rendering of management services by CPAs in situations where they will also be fulfilling the independent audit function is:					
(a) Compatible with the traditions of the auditor....	88%	50%	67%	66%	22%
Incompatible with these traditions..........	6	29	29	22	49
(b) Compatible with independence of the auditor.....	94	64	62	72	22
Incompatible with such independence..........	0	29	33	22	58
(c) An involvement which should be encouraged and extended......	94	57	48	59	18
An involvement which should be discouraged and restricted......	0	36	29	22	54

practitioners and 33% of the professors recorded such an adverse view. And while none of the major-firm respondents felt that the auditor's involvement in the rendering of management services should be discouraged and restricted, 35% of the other practitioners and 29% of the professors believed that the dual involvement should be restricted.

Surely, the data thus reported would demonstrate that significant numbers of the "reasonable observers" (a phrase contained in the Opinion of the Institute's Committee on Professional Ethics) probed by my questionnaire had misgivings regarding the possible conflict of interest involved when the auditor also involves himself in the rendering of management services. The data would confirm the doubts expressed by Delmer P. Hylton[18] regarding the compatibility of our consulting and auditing functions. The data which I obtained are entirely consistent with those reported by Arthur A. Schulte.[19]

My comments might well be countered by the refutation of the Schulte study contained in the article by Messrs. Carey and Doherty in the January, 1966, *Journal of Accountancy:*

> But nowhere in the questionnaire or the article interpreting it is there a definition of the term "management consulting." This term may well evoke a reaction different from that evoked by "management services," which is commonly used by the profession itself. In any event, it cannot be assumed that all the respondents to the questionnaire were familiar with the specific services offered by CPA firms as aids to management. The respondents may have read into the question types of "consulting" which in fact are not commonly engaged in by CPAs.

Messrs. Carey and Doherty then conclude:

> It is difficult to believe that reasonable observers —stockholders, creditors or other users of financial statements, or the business public generally— would see any conflict of interest in the fact that the auditor, in addition to giving an opinion on

[18] Delmer P. Hylton, "Are Consulting and Auditing Compatible?—A Contrary View," THE ACCOUNTING REVIEW, July 1964, p. 667.

[19] Arthur A. Schulte, Jr., "Compatibility of Management Consulting and Auditing," THE ACCOUNTING REVIEW, July 1965, p. 587.

the financial statements, also applied his technical knowledge and skill to the improvement of management's planning, control and decision-making processes.[20]

And because it was difficult for them to believe, Carey and Doherty determined to reject Professor Shulte's findings and to reiterate the conclusion of the Ethics Committee Opinion No. 12, that there is "no basic incompatibility" between management services and the attest function.

It might well be emphasized that the Carey-Doherty difficulty in believing did not move them to ask for a research study to be conducted by the AICPA or anyone else to develop data empirically in order to substantiate or refute the Schulte indictment; instead their very difficulty in thus believing was presumed to negate his findings.

Entirely fortuitously, my study did not use the emotionally-charged term "management consulting" and instead used the phrase approved by Carey-Doherty, namely "management services." And even though I used the phrase which would meet this Carey-Doherty test, the results obtained by my inquiry also reject their sanguine acceptance of the compatibility of the two functions.

The Probe Regarding Specific Kinds of Management Services

To proceed further, another of the questions of my study did do exactly what Carey-Doherty asserted that Schulte should have done, namely give the respondents an opportunity to express their views regarding "the specific services offered by CPA firms as aids to management."

One question listed a number of categories of management services that might be required by corporations. For each category of service the respondent was asked to indicate:

(A) Whether he believes such services *are now* being offered by public accounting firms to corporations for whom they are already performing the independent audit function.

(B) Whether he believes such services *should be* so offered.

The summary of the data obtained from this probe are contained in Table 6.

Section A of Table 6 compares the relative degrees of awareness that such services are being offered by accounting firms, under the circumstances described by the questions. Similarly, Section B of that table compares the degrees to which the two categories of respondents believe that the accounting firms should be rendering the services concurrently with their performing the attest function. It seems clear from the accompanying data that a probe directed to persons who are believed to be sophisticated members of the financial community as to their awareness of the auditor's involvement in these peripheral services, and their views regarding the appropriateness of such services under the circumstances here involved, would undoubtedly reject the Carey-Doherty hypothesis. Correspondingly, there is no study known to me which would support the assertion that if respondents were made better aware of what was swept into the compound of management services, they would not "see any conflict of interest in the fact that the auditor, in addition to giving an opinion of the financial statements, also applied his technical knowledge and skill to the improvement of management's planning, control and decision-making processes." Nor is there, to my knowledge, any reported study which would support the Opinion No. 12 of the Institute's Committee on Professional Ethics.

[20] John L. Carey and William O. Doherty, "The Concept of Independence—Review and Restatement," *The Journal of Accountancy*, January 1966, p. 38. (The dialogue between Professor Schulte and Messrs. Carey and Doherty regarding the appropriateness of the phrase "management consulting" ripened into an exchange of Letters to the Editor reported in *The Journal of Accountancy*, April 1966, pp. 32–34).

TABLE 6

RESPONDENTS' VIEWS OF COMPATIBILITY OF VARIOUS MANAGEMENT SERVICES WITH THE ATTEST FUNCTION
(Affirmative Responses)

Categories of Services*	A: Are you aware that service is being so rendered?		B: Do you believe that service should be so rendered?		C	
	Financial Community	Accounting Profession	Financial Community	Accounting Profession	Are you aware that service is being rendered? ("Big-8" Practitioners)	Do you believe that service should be rendered? ("Big-8" Practitioners)
	(All percentages pertain to affirmative replies)					
a) Review all phases of a business in connection with a plan to expand profits	36%	72%	28%	64%	88%	77%
b) Review all phases of a business in connection with a plan of the accounting firm's client to buy the business	63	84	60	75	83	83
c) Review all phases of a business in connection with a plan to reorganize the company	58	83	53	72	83	83
d) Appraise the organizational structure of the entity and the preparation of a manual defining responsibilities and lines of authority	19	77	8	61	88	83
e) Prepare an executive development program	8	38	3	31	59	59
f) Develop a plan of executive compensation (including "fringe benefits")	33	77	29	69	94	88
g) Develop sales forecasts and budgeting in connection with sales controls	29	63	19	49	94	94
h) Determine market potentials and plan profitable sales territories	8	52	3	31	83	65
i) Determine sales quotas and salesmen's incentives	7	49	6	30	83	77
j) Determine programs for increasing volume and profits through improved pricing methods	31	75	31	67	88	94
k) Analyze job functions and responsibilities of the entity's personnel	22	72	6	53	94	83
l) Determine the relative contributions of the entity's personnel	18	55	8	45	59	59

* The foregoing categories of services were culled from the mimeographed bulletin entitled "Services to Management" prepared by Peat, Marwick, Mitchell & Co., Management Controls Department. It is believed that the services here described find their counterparts in the offerings of the management services departments of each of the major accounting firms.

There is, however, an interesting aspect to the data obtained. If an inquiry were restricted to practitioners with the "Big-8" firms and excluded the users of the financial statements as well as practitioners with other firms and professors of accountancy, then the Carey-Doherty hypothesis would be confirmed. The "Big-8" respondents furnished overwhelmingly positive responses to the questions as to whether they knew the services were being offered and then whether they should be offered; these responses are tabulated in Section C of Table 6.

Now what is there in these data to confirm the thesis of "Old Myths and New Realities"? First, there is what Fulbright described as the "inevitable divergence, attributable to the imperfections of the human mind, between the world as it is and the world as men perceive it." But yet there is something more; I can see this saga regarding management services as conforming to the observation by Fulbright that "when our perceptions fail to keep pace with events, when we refuse to believe something because it displeases or frightens us, or is simply startlingly unfamiliar, then the gap between fact and perception becomes a chasm, and action becomes irrelevant and irrational."

Concluding Note

These remarks have revolved about three important areas of our theory and practice wherein my research confirmed the existence of gaps between the understanding by the profession and the corresponding understanding by the financial community.

These gaps regarding the understanding of generally accepted accounting principles, of the responsibility assumed by the auditor as an incident to his attest function, and the compatibility of the nexus of management services with the attest func-

tion, make the accounting profession vulnerable to sharp criticism.

Is there an escape from our present straits, some way out of our dilemma, some way of avoiding the Fulbright prophecy? I'm afraid that if there is such a way, it is not through a panacea; nor do I see it as coming through the organized profession as such. There is but one possible answer within the context of our profession—the universities and the schools of business which are included therein.

The scholar in the university has the unique role as John William Ward so astutely reminded us of being both a "cleric and critic," "being inside and outside our society, passionately committed to it, yet by that very passion inevitably somewhat alienated from it."[21] And specifically how shall we move to fulfill this mission of serving as cleric and critic, a mission which causes us to be inside and outside the profession, of being passionately committed to it but yet because of that very passion somewhat alienated from it?

First, we must move to effect a shift in the center of pure and applied research to the university and then to develop important channels for the dissemination of this research. Such a shift is also essential if the accounting faculty is to make its contribution to the advancement of the university's trinity of missions outlined by President Perkins—those of teaching, research, and public service.[22]

Second, we must move to effect a shift in the central interest of accounting education within the university from the accountant's "doing" to his "being and becoming." In my view it is only when we develop accountants in good numbers who have "a clear and compelling vision of his profession and of its relation to American life" (to adopt Professor Lawrence A. Cremin's phraseology); it is only when we teach accounting with a "liberating and liberalizing effect" (as President Buell Gallagher put it), that we will be able to overcome the crisis in communications, the crisis in confidence, the crisis in integrity which presently confronts the profession.

[21] John William Ward, "Cleric or Critic?" "The Intellectual in the University," *The American Scholar*, Winter 1965–6, p. 112.

[22] James A. Perkins, *The University in Transition* (Princeton University Press, Princeton, 1966).

Has the lure of providing profitable consulting service created a monster out of control?

Our Profession's "Jurassic Park"

By *Abraham J. Briloff*

*The collage of numbers from several sources discloses that consulting income is becoming of greater importance to the larger accounting firms. The author dis-
cusses the implication of this trend
major issues important to the profess
such as independence and non-CPA
ership.*

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proposal be deemed inimical to the
al objectives of the members of the res
tive firms. Thus, having been set free, the partners of the consulting entity could proceed to its incorporation to be followed by a public offering of shares or a merger into a financial institution. As many of the profiles included in the UN Survey make clear, there are no restrictions on the ownership of the firms in the industry. For example, Mercer Consulting Group, Inc., the fourth largest, is a subsidiary of the publicly-owned Marsh & McLennan Companies, Inc., the Alexander Consulting Group, Inc. is a subsidiary of Alexander & Alexander Services, Inc. It is not entirely presumptuous to suggest that Andersen Consulting could find "synergy" by being merged into say Citicorp, Chubb, or AIG. The Andersen people would, as a consequence, be enriched beyond the dreams of avarice of most mortals.

In this connection the concluding paragraph of the UN discourse is relevant, thus:

> As attitudes about consulting change from one of the client as a sick firm in need of assistance, to a perception of the consultant as a partner in generating new ideas and managing change—the need for secrecy may be reduced. Because of the complexities of ownership in transnational corporations, partners in large consulting firms may be eager to cash in on past successes, marketing part of their shares in the firm on stock exchanges. The goal of increased professionalism and attempts by management consultants to be more business-oriented are often incompatible.

Clearly, I do not begrudge the affluence being derived by my colleagues from their management peripheral proclivities. Instead, I am importuning the firms compromising the accounting oligopoly to abandon their "accountants and auditors"

appellation and, instead, re
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vices which involve the issuing or
accounting, or related statements or any opinion on, report on, or certificate to such statements where the practitioner is acting as independent accountant or auditor having expert knowledge in accounting or auditing." ❑

Abraham J. Briloff, PhD, CPA, is Emanuel Saxe Distinguished Professor Emeritus, Baruch College, The City University of New York and a member of the firm AJ & LA Briloff, CPAs. Professor Briloff has written extensively on the accounting profession, including articles in The CPA Journal. *Professor Briloff acknowledges with appreciation the assistance of his graduate assistant, John Powers, CPA, in the preparation of this article.*

The Business Newspaper for the Tax and Accounting Community Vol. 14 No. 5 March 13-April 2, 2000

ACCOUNTING TODAY

Commentary

An accountancy manifesto for the Third Millennium

by Abraham J. Briloff

Abraham J. Briloff

I am taking this occasion for a quantum leap to provide a nexus of proposals that I believe could serve to advance the objectives of the accounting profession, especially regarding its role in reporting on the financial statements of publicly owned enterprises.

To wit: I would abort the present requirement that such financial statements carry the imprimatur from independent CPAs. This is because the major firms that are principally responsible for those audits are no longer firms of CPAs, nor are they as independent as they are perceived to be by the financial community.

As a consequence of these proposals, the determination and implementation of the accounting precepts and practices, which would best reflect the financial condition and operations of the enterprise would become the sole responsibility of management. This is essentially the prevailing reality: the public's myth regarding the independent audit is just that, a myth.

Observations of the prevailing marketplace, especially insofar as initial public offerings, Internet shares, et al, are concerned, might indicate that active participants are oblivious to the financial statements. How else could one explain the market capitalizations of corporations that have no earnings expectations into the foreseeable future, where their P/E ratios can only be stated as "infinity," where price volatility can be as much as 10, 20 or more percent, within a single hour, where the market capitalizations of the newly-sponsored entities could exceed that of GM or IBM.

Nor could the financial statements as presently developed and disseminated be deemed to be really relevant for the presumptively efficient market. We are told on the highest authority that the market is "irrationally exuberant." Whether it be "irrationally exuberant" or "irrationally depressed" it could not be deemed to be predicated on our financial accounting model, unless that model is correspondingly irrational.

Let the Financial Accounting Standards Board take a well-earned sabbatical. The board has, throughout its existence, promulgated a plethora of standards and other directives to last well into the Third Millennium. The accounting profession, or industry, deserves a respite.

The board should then reconstitute itself as a think tank, possibly as the "first among equals," with other research centers housed in universities or consortia of academic or professional institutions.

Research endeavors in the areas of DNA and genome mapping are carried out under such arrangements — why not in accountancy? It should then be the responsibility of management to determine which of the resultant determinations should be implemented to best reflect the economic reality of the enterprise.

To the extent that developments in the economic or political sphere call for a further evolution of our accounting concepts and precepts, they might well be the responsibility of our scholars in academe.

The Securities and Exchange Commission might well become one of the research centers referred to above; in that event, I would have the SEC share the primus inter pares slot assigned to the FASB. The Chief Accountant is in an enviable position to recognize accounting irregularities or unwarranted aggressive accounting. I would then urge the SEC to spread its

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findings on the Internet, thereby giving notoriety to those responsible for the aberrant practices. As Justice Brandeis observed, "Sunlight is the best disinfectant, and electric light is the best policeman."

The acid test for chief financial officers might well be whether he or she has probed the findings of the various research centers to determine which provide the best guide to the "truth."

To advance the effectiveness of the managerial responsibility I would expect that the role of the independent audit committee would be made even more vital. In this connection, I have urged that the committee be provided with cadres of advisors who would guide the committee on raising the appropriate questions for management and considering the completeness and fairness of management's responses.

The prevailing psychedelic condition is all too remindful of the catatonic culture described by William Ripley in his "Main Street and Wall Street" (1927). If then, there were to occur a cataclysmic phenomenon corresponding to that of the 1930s, we might anticipate a demand from society for really independent auditors corresponding to society's image of that profession back in the 1930s. If that were to occur, I would look for what I have dubbed a priesthood, i.e., professionals who would dedicate themselves exclusively to the development and implementation of accounting precepts that would produce the financial statements of publicly owned enterprises as fully and fairly as would be feasibly consistent with the evolving profession's discipline.

Thus, those committed to this calling would forswear the detractions of peripheral services like taxation and consulting. Most assuredly, they would find it anathematic for their firms to be a part of a financial conglomerate or otherwise 49 percent owned by outsiders.

There is a prototype for this professional undertaking; it takes the shape of the role of the "forensic auditor" when he or she is called in for a pathological probe in the wake of an audit failure. I have dubbed that role as that of the Certified Independent Forensic Auditor – or truth advocate. Such an auditor would be neither an adversary nor an accomplice of management; his or her role would be as the advocate of the "truth."

(See MANIFESTO page 60)

Because the cost to be burdened against the entities would exceed that which presently prevails, this CIFA engagement might be implemented on a biennial or triennial cycle. In view of the increased role and responsibility vested in management and the independent audit committee, and the intensity of the CIFA process this lessened frequency should prove adequate.

Do Management Services Endanger Independence and Objectivity?*

By Abraham J. Briloff, Ph.D., CPA

HEADNOTE: The well-known author takes serious exception to the published conclusions reached from recent surveys made of attitudes of a number of groups toward the involvement of accountants who are independent auditors in consulting work. He maintains that the survey data clearly point to conclusions that do not support such consulting by accountants retained as auditors, and proposes limiting such consulting to activities which have a clear and logical nexus with the audit. Disclosure of the extent of such consulting work, he believes, is in the public interest.

Independence and objectivity are the very special transcendent qualities required of certified public accountants as an incident to fulfillment of our essential professional responsibility to society, that of the independent auditor for publicly owned enterprises. In that role, we serve as the surrogates for society to "fight the figures and find the facts"[1] of the subject enterprise, and to write its history with all our skill, "and not flatter me at all; but remark all these roughnesses, pimples, warts, and everything as you see me, otherwise I will never pay a farthing for it."[2]

Three announcements made during the past year raise serious questions regarding the auditors' independence and objectivity; for present purposes, however, I shall point up the ways in which we may be compromising our own independence and objectivity as shown in the response to the issues raised by the studies on which the announcements are based. The announcements, which serve as the frame of reference for this article, are:

- A Survey of Perceptions, Knowledge and Attitudes Towards CPAs and the Accounting Profession ("The Harris Report").
- Public Perceptions of Management Advisory Services Performed by CPA Firms for Audit Clients ("The POB Report" in recognition of its sponsorship).
- Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment ("The Anderson Report" in recognition of George D. Anderson's Chairmanship of the AICPA committee responsible for its creation).

The Harris Report

The December, 1986, *Journal of Accountancy* published an article dealing extensively with the results of the survey

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[1] As suggested by the late Colonel Robert H. Montgomery.
[2] According to Oliver Cromwell's directive to his portraitist.
* The author expresses appreciation to his graduate assistant, Helene Rubenstein, for her assistance in the preparation of this article.

Louis Harris & Associates; the article carried the following headnote: "The bottom line is a Louis Harris public opinion poll on CPAs and the accounting profession. CPAs lead other professionals, leaders in standing on ethics and morality." In addition the survey found that almost 80 percent of the leadership groups polled gave CPAs positive ratings on their objectivity and more than 90 percent asserted that "CPA firms exercise independent and objective judgment in performing audits of company financial statements."

This is, of course, most gratifying to those of us who have been deeply involved in our great profession. However, I have some serious misgivings regarding the independence and objectivity of the conclusions reached in the Harris report and in the article in the *Journal* on certain key issues. By omission and commission the presentations fail to point up serious misgivings the public has regarding accountants and accountancy as reported in the study.

. . . serious misgivings regarding the independence and objectivity of the conclusions reached . . . on certain key issues.

"Auditing Firms Give In Too Easily . . ."

First, the editors of the *Journal* have ignored the following from pages 9–10 of the Harris Report:

> —*Auditing firms give in too easily to pressure to 'bend the rules' in their clients' favor.* This criticism also meets with a mixed reaction: the general public goes along with it by a close 47-44%, but the 'knowledgeable' group in the public reject it by a narrow 47-46% along with stockowners by 49-44% and the special publics who don't agree by 54-44%. All of the corporate types from small, medium, and big business reject this charge against independent auditors, as do audit committee members, creditors, attorneys, congressional aides and academics. The exceptions who believe the charge are state and federal officials by 50-45%, media types by 60-38%, and security analysts by 60-37%.

The foregoing was predicated on the findings tabulated in Table 115 of the report which summarized the results of Question 11-5: i.e., "Please tell me if you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the following statements about independent firms and auditors . . . Auditing firms give in too easily to pressure to 'bend the rules' in their clients' favor."

The report down played the responses to the questions. I find it difficult to comprehend the rather sanguine commentary on the critical data set forth in the table. The reference to "mixed reaction" to, and even rejection of, the condition presumed by the question appears to be predicated on the fact that majorities of a number of the groups surveyed did not provide affirmative responses. Minorities of 44 percent of the overall Leadership group, 42 percent of Business, 44 percent of Credit Grantors, 43 percent of Attorneys, 50 percent of Government Officials, 41 percent of Congressional Aides, 46 percent of Academics were of the view that "Auditing firms do give in too easily to pressure to bend the rules in their clients' favor." Financial Analysts and the Media provided overwhelming majority affirmations of the question in issue.

Frankly, if "only" 40 percent of my students were to assert that I "gave in" to pressure from the Administration of my college in the assigning of grades, say, I would not blame any outsider for questioning my independence and objectivity. And, if in a poll of our citizenry we were to find that "only" 40 percent of the respondents asserted that Congressmen, Senators, the President gave in to pressures from, say, major contributors, would we be comfortable about our American Democracy? Or, if "only" 40 percent of our citizenry were to assert that our judges "give in too easily" to political pressures, would we not have serious concern for our independent judiciary?

In short, while the universe of respondents might have a generalized feeling that CPAs are trustworthy, independent and objective in the abstract, the critical question is whether we possess those attributes in making our critical judgment calls. Certainly the Table 115 results should have been importantly and critically highlighted and included in any article wherein the many positive traits of CPAs are put forward. However, the mode of presentation in the Harris Report made these data seem entirely innocuous—so much so that they were not even alluded to in the extensive abstract—included in the article appearing in the December issue of *The Journal of Accountancy*.

. . . the profession's commitment to taking on all types of management advisory services (MAS) by CPAs.

The Auditor Independence/MAS Controversy

I turn to a second major misgiving with the Harris Report and *Journal* article therefrom; this has to do with the profession's commitment to taking on all types of management advisory services (MAS) by CPAs.

At page 31 of the report we are told (predicated on data compiled in Table 79):

> Two basic findings emerge from this important series. First, the publics most critical to the accounting profession are convinced that just to be in the audit business is far too narrow a scope. But they draw the line and strongly suggest that there are distinct limits to the areas of potential operation. In turn, this means that there

probably should be some orderly mechanism to determine what are proper areas and what are not.

Second, certain of the eight areas tested emerged as overwhelming choices, fitting and appropriate, in their judgment, for CPA firms to be in. These include assisting in computer hardware selection and computer software design or selection, general management consulting, educational programs, actuarial services, and service bureaus for various record keeping [services]. Taken together, these five areas constitute a broad base for interfacing with corporate America. Each contains within it much room for expansion and development. . . .

Ignored in this context are the especially relevant and critical data garnered by the Harris Associates in response to their Question 8g, i.e., "Do you believe or not believe that when independent auditing firms serve as advisors to a business on tax matters, management systems, or financial matters, it affects their ability to be objective when auditing a client's financial statements?" The responses to this query, tabulated in Table 90, demonstrated that fully 57 percent of the overall leadership group gave "negative ratings," i.e., asserting that the auditor's independence and objectivity would be impaired by the concurrent rendering of the aforesaid services. This composite response reflects corresponding adverse ratings from: Audit Committee Members (57 percent), Attorneys (68 percent), State and Federal Officials (75 percent), Congressional Aides (71 percent), Media Persons (83 percent), Financial Analysts (57 percent). The composite was reduced by the adverse ratings from Business Respondents (50 percent), Credit Grantors (56 percent), and Academics (55 percent).

Such data lead inexorably to the conclusion that in the view of the publics polled for the survey the rendering of tax and MAS services would compromise the auditor's independence and objectivity where such peripheral services are performed concurrently with the audit.

. . . the question as to whether such an expansion is appropriate . . . where the firm is also involved as the independent auditor.

The report reflected the foregoing data in an observation at page 34 (page 32 of the *Journal* article). However, these critical data are integrated into a segment which deals essentially with the distinction between CPAs and other professionals involved in the consultative pursuits. Instead, Table 90 data should have been juxtaposed with those reflected by the aforementioned Table 79. Thus, while condoning the expansion of the catalogue of services which might be appropriately rendered by an accounting firm, respondents seriously question the appropriateness of the performance of such services for clients which are concurrently the subject of the firm's independent audit.

In short, while respondents might look with favor on an accounting firm's expansion of tax and management consultative services, they are anything but comfortable when they are confronted with the question as to whether such an expansion is appropriate under circumstances where the firm is also involved as the independent auditor.

The POB-Sponsored Study

When the Harris Report was being disseminated, Public Oversight Board of the SEC Practice Section of the AICPA Division for Firms released the results of the study of "Public Perceptions of Management Advisory Services Performed by CPA Firms for Audit Clients." This POB report complements the Harris report insofar as the critical MAS issue is concerned. The POB report summarizes the responses obtained from a probe of 1059 respondents, including: 33 Financial Writers; 94 Investment Bankers; 111 Business School Deans; 122 Accounting Professors; 125 Chief Executive Officers; 125 Financial Analysts; 136 Audit Committee Chairpersons; 143 Attorneys; and 170 Bank Loan Officers.

After presenting (Table 1) the extent to which the respondents were knowledgeable regarding the accounting profession and the management advisory services issue, the POB report proceeded to Table 2 to tabulate the responses to Question 6, to wit:

> Which of the following statements comes closest to expressing your views about management advisory services?
>
> CPAs should be allowed to perform a full range of management advisory services because impairment of audit independence and objectivity is not a problem.
>
> CPAs should be allowed to perform only those management advisory services where it is clear that audit independence and objectivity cannot be impaired.
>
> CPAs should not be allowed to perform any management advisory services since there is always the possibility that audit independence and objectivity may be impaired.

To this crucial question, 12 percent of the respondents would allow the audit firm to render the full range of services, whereas 9 percent would proscribe all management advisory services. Fully 75 percent would confine the audit firm to those services where "it is *clear* that audit independence and objectivity *cannot* be impaired." Excepting for the CEOs (of whom 67 percent opted for this view), and Business School Deans (64 percent), the other group tabulations ranged from 72 percent (Investment Bankers) to 82 percent (Audit Committee Chairpersons).

Torpedoing a Couple of Sacred Cows

This extraordinary POB report does damage to several axioms held by MAS advocates, thus: Table 13 which tabulated the responses to the portion of Question 5, which read:

"If the personnel performing the management advisory services are not personally involved in the audit then impairment of independence and objectivity is not an issue."

Affirmative responses were obtained from but 29 percent, contrasted with 67 percent expressing disagreement.

Table 14, which tabulated the responses to another phase of Question 5, "CPAs who perform management advisory services are better able to conduct more informed audits than those who do not perform these additional services."

The responses: 38 percent favorably disposed to the proposition, compared with 52 percent in opposition. (The only sectors tilting towards a favorable response were Loan Officers (50-42) and Accounting Professors (54-38).)

Some Additional Insights

The responses compiled in Table 11 should be especially distressing to accountants and the SEC. Here are tabulated responses to another part of Question 5, "All management advisory services performed by the auditing firm should be reported in the client's annual report . . ." Sixty-eight percent were in agreement, with but 26 percent of a contrary view. Only the CEOs registered a majority negative vote (59 percent v. 36 percent). Audit Committee Chairpersons were only grudgingly in the affirmative (50 percent v. 47 percent). This POB study sounds the tocsin loudly and clearly in one critical respect by insisting that the SEC resurrect ASR No. 250 "Disclosure of Relationships with Independent Accountants (1978)," with even more elaborate exposure.

Table 5 is especially intriguing from the perceptions perspective. This table interfaces the respondents' own views with those which the respondents believe *others* hold. Of those who would permit the CPAs to provide the full range of services only 15 percent believe that others would be of a like mind, 57 percent presume that such services would be performed only where there would be a clear absence of contamination; 10 percent expect that the others would ban all of these peripheral services. The remaining 18 percent could not fathom the views of others. From this we can see that even those who possess the most liberal view on this issue recognize that they are in a distinct minority.

But Discredited Axioms Die Hard

Given the foregoing unequivocal perceptions it might well have been expected that the POB would finally have conceded that some overt response was called for to impose significant constraints on the range of services offered by its constituency. Instead, A.A. Sommer, Jr., the POB Chairman, asserts in his prologue to the study:

> Not surprisingly, like any such survey, this one will lend itself to varying interpretation. Advocates of unfettered MAS expansion will find in some of the data confirmation of their conviction. Proponents of greater restraint will find comfort in other parts of the report. . . .
>
> As in 1979, the Board still knows of no instance in which it can be demonstrated that the provision of MAS to an audit client interfered with independence in performing the audit function. . . .
>
> To the best of our knowledge this is the first comprehensive survey of the perceptions that exist among interested and involved groups with respect to their relationships that exist between MAS and audit services.

. . . some overt response was called for to impose significant constraints on the range of services offered by its constituency.

However, in contradiction to these assertions, there is not a single table in the report which could give comfort to those who advocate "unfettered MAS expansion." It would appear that the POB has determined to put out of sight and out of mind cases of the compromising of auditor independence by concurrent performance of advisory services. Further, I am confident that had the POB staff endeavored to do so, they could have found reference to many more or less comprehensive studies of this issue by scholars in academe and elsewhere over the past score of years.

It is difficult to understand the Chairman's views expressed in the aforementioned prologue. It would appear from the results of its study that the POB should be required to conclude that constraints need be imposed on the MAS activities of CPA firms in connection with clients that they audit. This would require urgent and immediate study to determine the extent of such constraints.

Finally, the Anderson Report

The report of the AICPA Special Committee on Standards of Professional Conduct for CPAs, under the chairmanship of George D. Anderson, entitled "Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment" discourses most extensively regarding the MAS/Independence issue.

Among the precepts proclaimed by the Committee we find the following:

> A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member should be independent in fact *and appearance* when providing auditing and other attestation services. (Emphasis supplied.)

Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The standard of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that *may appear* to impair a member's objectivity in rendering attestation services. (Emphasis supplied.)

Most certainly no one could argue with those high-sounding phrases. But the committee equivocated regarding the circumstances when there might be a contamination of the foregoing precepts as an incident to the auditor's MAS activities. Thus, from "Meeting Clients' Needs for Services:"

As business has become more complex, client's demands for outside professional services have increased and the profession has steadily expanded the scope and nature of its services . . . the expanded scope of services builds upon and leverages the strengths of the profession and its reputation for competence, integrity, and objectivity.

. . . Not only has the nature and scope of practice changed, but in many firms, some of the principals or partner equivalents and many professional employees may be other than CPAs. Yet those firms practice as CPA firms, and the public and the third parties continue to look upon them as engaged primarily in the practice of public accounting. . . ."

We are then instructed regarding the "Issues for the Profession," to wit:

In 1979 the Public Oversight Board (POB) issued a report, "Scope of Services by CPA Firms," that dealt primarily with the issue of whether to limit scope of services that may be furnished to SEC audit clients.

. . . Seven years after the report of the POB, the issues raised by the expansion of services persist.

. . . As more of the profession's efforts go into the pursuit and development of other services, the profession may lose the special status conferred upon it by law and public opinion.

Public concern about the independence of the CPA must be a paramount concern for the profession, and the issues arising from the growth of nonattest services must be dealt with. If they are not, demands could arise for drastic actions, such as divestiture of the nonattest functions or loss of licensing. The profession must act before such a situation comes to pass.

With the foregoing as its predicate, the committee proceeded to a deliberation of the relevant Code Provisions and Guidelines, thus:

The proposed Standards of Professional Conduct impose a measure of self-restraint and self-regulation by calling upon AICPA members to use their judgment in applying broad standards to determine what is consistent with professional conduct in the provision of nonattest services. The Standards require that:

Members should consider several factors in deciding on the scope and nature of services. The public interest aspect of certified public accountants' services requires that such services be consistent with the public expectations of acceptable behavior for certified public accountants. Integrity requires that service and the public trust not be subordinated to personal gain and advantage. Objectivity and independence require that members be free from conflicts of interest in discharging professional responsibilities. Due care requires that services be provided with competence and diligence.

Each of these standards represents constraints on a member's ability to provide specific services in individual circumstances. In some instances, they may represent an overall constraint on the magnitude of nonaudit services that might be offered to a specific client over time. No hard-and-fast rules can be developed to help members reach these judgments. A member must be satisfied that standards of professional conduct are being adhered to in this regard.

Non attest services should not be limited by imposition of arbitrary restrictions. Rather, the acceptability of an activity must be determined by members in keeping with the spirit of the proposed Code.

With all these "shoulds" canonized by the profession there is little question but that the high-sounding rhetoric regarding independence and objectivity is destined to be implemented as nought but precatory platitudes.

If the public is not let in on what is going on, how can it reach a perceptual judgment?

But Then, "Let's Tell It Like It Is"

Accepting the view that an accounting firm shall be the sole judge and jury regarding the possible contamination of its objectivity and independence is not enough. It is the profession itself which has prevailed on the SEC to prevent the public from becoming aware of just what services are being performed by the independent auditor concurrently with the performance of an audit. If the public is not let in on what is going on, how can it reach a perceptual judgment? There is no other profession charged, as is the independent auditor, with the transcendent third-party responsibility,

hich is correspondingly permitted to carry on potentially nflicting activities without full, fair and open disclosure.

The CIA or NSC might be deemed to be exceptions to this "Sunshine Rule;" but as we now have learned, much to our grief, even these agencies cannot be permitted to carry on without let or hindrance.

Quo Vadis?

How, then, shall we proceed to a resolution of this nawing, recurring Independence/MAS controversy? After nost a quarter of a century of probing this issue, herewith are my considered views:

By way of prologue, I cite a critical paragraph in the Opinion of Warren E. Burger who, as Chief Justice of the Supreme Court of the United States, delivered the unanimous verdict of the Court in *U.S. v. Arthur Young & Co.*, 465 U.S. 805 (1984), thus: "Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. . . If investors were to view the auditor as an advocate for the porate client, the value of the audit function itself might d be lost."

With this standard in mind I propose the "unbundling" or "uncoupling" of the audit function from the management advisory or consultative services—at least insofar as the principal auditors for our publicly owned corporations are concerned. So it is that I propose that those firms which derive at least 50 percent (say) of their revenues from the audit of SEC Registrants should be required to divest themselves completely of their peripheral-service sectors.

What benefits would be derived from such a divestiture? essential objective would be to provide effective insulation for the independent audit function from the possibility of contamination from the peripheral services. Beyond that, the anti-competitive practices of "reciprocity" and "subsidization" which prevail presently would be minimized. Then, too, more reliable data would be obtained regarding the economics of the segregated firms. Such data are deemed essential for the effective functioning of the regulatory and/or self-regulatory process.

Those who continue in the audit sector should find the strictly committed to the fulfillment of the independent audit at the highest levels of professional responsibility—without distractions from other dimensions. Thus, the less restrictive ethical standards which prevail in the MAS pursuit would not corrode those presumed to govern the recognized profession of the certified public accountant.

This divestiture proposal, if implemented, would not be as draconian as might appear at first blush; this is because many of the functions presently subsumed in MAS might well be required to be performed as an incident to the effective fulfillment of the independent audit responsibility. Such services would include, *inter alia*, actuarial and appraisal valuations, determination of appropriate reserve levels for banks and insurance companies, reviews of compensation and perquisite plans for their appropriateness and reasonableness, study of the entity's organizational structure, adequacy of procedures for environmental protection, and above all, an in-depth study of the internal control system of the enterprise, far beyond that presently required by our generally accepted auditing standards. In short, we profess ubiquity when offering management advisory expertise; let us integrate all of that competence into the audit responsibility. Most assuredly, should the auditor commit himself to the full range of services *as an integral part of the independent audit* the audit responsibility would once again certainly be economically productive.

In sum, these proposals are not intended to have an inimical effect on the power or the purse of my colleagues in the profession. Instead, I am striving to insure the fulfillment of the independent audit function—the function which gives accountancy its professional status, the sole function for which it enjoys a monopoly under our Securities Laws, and which is the very essence of our endorsement by our respective legislatures as a legally recognized, duly qualified profession.

Coda

The point of this article can be stated most succinctly thus: While the accounting profession has been engaged in an endeavor to impress the public with its independence and objectivity, it would appear that we have succeeded best in deceiving ourselves. Ω

PREPARED STATEMENT OF BEVIS LONGSTRETH

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FORMER COMMISSIONER OF THE
SECURITIES & EXCHANGE COMMISSION, 1981–1984
RETIRED PARTNER, DEBEVOISE & PLIMPTON

MARCH 6, 2002

Reforming the Audit Profession

My name is Bevis Longstreth. I am a retired partner of the New York law firm, Debevoise & Plimpton, where I spent the bulk of my professional career. From 1981 to 1984, I served as a Commissioner of the SEC, a post to which I was appointed twice by President Reagan. Recently, I served as a member of the Panel on Audit Effectiveness, which released its final Report and Recommendations in August 2000. For 5 years following retirement from law practice, I taught a course on the regulation of financial institutions at the Columbia Law School.

I welcome this opportunity to address the Committee on the subject of reforming the audit profession. I am here because my professional experience and background give me some basis for contributing to your treatment of this urgent need for reform. I represent only myself, but in so doing, I hope to offer opinions that will resonate with other public investors in our Nation's securities markets.

I want to speak about the audit profession, a once proud profession now embattled and greatly in need of reform.

My thesis is simple. The profession needs reform in two major respects:

1. An effective rule preventing the delivery of nonaudit services to audit clients.
2. An effective system of self-regulation.

Despite the SEC's adoption of Rule 2–01, the threat to an auditor's independence from performing nonaudit services allowed by the Rule remains palpable.

Despite the enlarged charter of the Public Oversight Board, until recently the most promising vehicle for achieving some limited improvement in self-regulation, an effective system of self-regulation does not exist and cannot be achieved without legislative reform. No greater proof of this fact could be found than the POB's unanimous vote on January 20, 2002 to terminate its existence in reaction to the efforts of the profession's trade association and the CEO's of the Big 5, in private meetings with the new Chairman of the SEC, to circumvent the POB by proposing still another voluntary oversight entity.

While the reforms I advocate offer no guarantee against audit failures, they should sharply reduce the size and number of these occurrences without impairing the ability of firms to prosper. Indeed, I believe that, without these reforms, the profession, which has been its own worst enemy, will continue to spiral downwards until legislation denies it the exclusive economic franchise on which its success was built from the beginnings of the securities laws in 1933 and 1934.

The Need for an Exclusionary Rule for Nonaudit Services

Arthur Levitt, with strong assistance from Lynn Turner, his Chief Accountant, showed boldness in their efforts to achieve a lasting solution to the vexing problem of independence. In the SEC's Proposing Release, they invited comment on a simple rule excluding an auditor from providing nonaudit services to audit clients. To many people away from the narrow corridor extending from the financial capital of the world that is still New York City to the separated powers of Government in Washington, the idea that boldness, and even personal courage, would be required for a governmental powerhouse such as the SEC to propose such an obvious, and widely supported, rule is strange. Yet, I am positive that it took both boldness and courage to issue the Proposing Release. That is because, by so doing, the SEC knowingly unleashed an unprecedented attack from those it was seeking to regulate, as it was charged by Congress to do, for the protection of the investing public and otherwise in the public interest. The ensuing battle, and it was clearly a battle, pitted a legally created monopoly, dominated by five global accounting firms, against the SEC. Three of the five, representing solely their private business interests, rejected any meaningful restrictions on the free play of those interests. Despite the profession's multipronged assault, the SEC, acting upon the need for greater independence, a need long recognized by virtually every group that is considered the issue (and there have been many), went ahead with its proposals, inviting comment and conducting 4 days of public hearings.

There were almost 3,000 comment letters. One hundred witnesses testified for about 35 hours. The battle raged far beyond the frontlines at 450 5th Street, NW.

Given the sharpness of the debate, and the transparency of the private versus the public interest, there was more at stake in the outcome than just the independence of auditors. The independence of the SEC, itself, was being challenged as the accounting firms did all they could, on Capitol Hill and throughout the business and legal communities, to bring political pressure to bear against a proposal, the exclusionary rule, that could not be defeated by argument on the merits. At an informal meeting during the pendency of the rule proposal, involving representatives of the SEC and the POB, I was told by a veteran Washington insider that there wasn't a significant law firm in DC that hadn't been lined up by the profession to assist in its battle.

In the tumult of the moment, many leaders of the accounting profession—and here I must say I am not including leadership of the POB—forgot their profession's origins as one granted exclusive rights, and reciprocal duties, to perform a vital public service. Although affected by the public interest as much as, or more than, any public utility, these leaders were demanding freedom from serious oversight or constraint. From my vantage point as a member of the Panel on Audit Effectiveness who had a career of experience working closely with literally hundreds of responsible public accountants, I became increasingly convinced that the leadership of the profession was seriously, perhaps disastrously, disserving a worthy profession.

A rule on independence was adopted on November 21, 2000, shortly before Arthur Levitt's term expired. The adopting release was 212 pages long. It was meticulously detailed. In that detail a careful reader can discern the parry and thrust of the battle that raged over each principle sought by the SEC and every word and sentence by which each surviving principle was to be expressed. I am sure if Lynn Turner bared his back and shoulders, we would find more wounds than we could count, inflicted by a profession in the hands of hostile and shortsighted people.

The release acknowledges in several places that, in the SEC's view, the final rule struck a reasonable balance among the commenters' differing views. The release also claims the rule achieves the SEC's important public policy goals. I wish these statements were true. But it is my firm opinion they are not. There is a large gap between the sound policy goals sought by the SEC and the actual accomplishments that can realistically be anticipated by the rule. When the smoke had cleared, it was apparent to this observer that the profession had won the battle. Importantly, however, it was just one battle in a war the outcome of which, when it comes, sooner or later, will be different.

About the rule, let me be clear. I am not saying that, on balance, we would be better off without the rule. It is useful, despite its breathtaking complexity, which has proven very costly for the best intentioned issuers. I speak here as Co-Chair of the Audit Committee of a large public company that is continually struggling to understand the rules and assure that both it and its auditor are in compliance.

The rule is not even "half a loaf;" nonetheless, it is a step in the right direction. I say that for three reasons. First, because it was a bold and honorable battle hard fought by the SEC. In future battles this effort will count for a lot, despite the many compromises. Second, because the policy goals elaborated in both releases, and supported by abundant testimony and comment, provide a compelling foundation for carrying the battle forward in the halls of Congress, where, it has become clear, the fight must now be taken. And third, because the disclosure requirement is proving of particular use in focusing public attention, not to mention the attention of audit committees, on the amazing growth in nonaudit fees paid to their auditors.

In thinking of the disclosure requirement, it is important to remember that the SEC in 1978, based on what it then saw as a growing amount of nonaudit services being performed for audit clients, adopted a very similar disclosure rule, ARS 250, which was swiftly repealed in 1982 as the consequence of massive pressure from a profession that was beginning to be adversely impacted by disclosure. Since then, as we now know, nonaudit services have increased exponentially.

So what is wrong with the rule? In many respects it can be criticized. I want only to address one big problem. The SEC adduced strong and abundant evidence in the rulemaking process, as summarized in III(c)(2)(a) of the Adopting Release, that providing to one's audit client nonaudit services of any kind or kinds, if large enough in terms of fees paid, may impair independence. Despite this powerful predicate for rulemaking, the rule adopted fails absolutely to address this concern.

The SEC describes the rule as implementing a "two-pronged" approach:

1. Requiring separate disclosure of audit fees, financial information-related service fees, and other nonaudit fees.

2. Prohibiting nine specific nonaudit services believed by the SEC to be, by their very nature, incompatible with independence.

Economic incentives derived from nonaudit work, no matter what their magnitude, were not defined as being, by their very nature, incompatible with independence. In failing to address this matter, the SEC ignored a mountain of persuasive argument.

This giant omission touches upon one of the two fictions I am going to address. Fiction Number One is the claim that payment by an audit client to its auditor for consulting and other nonaudit services, no matter how large, will never impair independence, that is, will never have an adverse effect on the quality of the audit or be seen to have such an effect in the eyes of the investing public.

It defies common sense to claim that large payments for nonaudit services, which management could easily purchase, or threaten to purchase, from service providers other than its auditor, do not function as a powerful inducement to gain the auditor's cooperation on how the numbers are presented.

Audit account partners are expected by their firms to establish close relationships with the managements they serve. They are expected to cross-market to management as full a range of nonaudit services as possible. And they are compensated by their firms on the basis, among others, of how much revenue they produce from their audit clients. Their stake in maximizing revenue from these clients through cross-marketing of nonaudit services is as natural and compelling as any financial reward could be. To claim these incentives have no adverse impact on both the fact and appearance of independence is a fiction, pure and simple.

To be fair, I should point out that the rule contains a general standard, 2.01(b), that declares an accountant not independent if, in fact, or in the opinion of a fully informed, hypothetical "reasonable investor," the accountant is not capable of exercising objective and impartial judgment. Absent a "smoking gun," this "capability" test would seem to create a virtually insurmountable hurdle for the SEC.

The disclosure requirements of the rule, which enjoy the truth-eliciting feature of proxy rule sanctions for misstatements, have already illuminated the seriousness of the economic incentive problem. On average, for every dollar of audit fee paid, clients paid their auditors $2.69 in fees for nonaudit services. In other words, nonaudit fees represent, on average, 73 percent of total fees paid to auditors. This percentage is astoundingly large, even when one discounts it for lumping together audit-related services such as work on financials in registration statements. Of course, this is just the average. As *The Washington Post* reported in a June 13, 2001 editorial: "KPMG charged Motorola $39 million for auditing and $623 million for other services. Ernst & Young billed Sprint Corp. $2.5 million for auditing and $63.8 million for other services."

If Rule 2–01 with all of its promise and detail, allows nonaudit service fees, as a percentage of total fees, to represent even a fraction of the 73 percent average that we now know prevailed on the eve of the rule's adoption, the rule must be counted a failure. Given the compromises reached in defining the "terrible nine" services that may not be provided, I am afraid the percentage will not be substantially lessened by these so-called "bright line" exclusions. Of course, there remains the often powerful effects of disclosure on corporate behavior and, in this case, on the behavior of the audit committees.

Disclosure might encourage the growth of "best practices," as exemplified by TIAA/CREF, for example, which denies its auditor any nonaudit business. Over some period of years, the rule's disclosure could cause a growing number of audit committees to back away from using their auditors for any significant amounts of nonaudit work.

But I wouldn't bet on it. I fear Rule 2–01 will turn out to be the Maginot Line for Independence, crisscrossed with trenches, barbed wire and gun emplacements, all pointing in one direction only, capable at will of being thoroughly outflanked.

One indication of the rule's failure in addressing the impact of large payments for nonaudit services can be found in the way the Big 5 presented it to their audit clients. I have been exposed to only one sample, which I fear may be illustrative of what others did, at least in oral presentations. Overall the message of this firm's booklet on the rule, provided to audit committees and to management of its audit clients, is that the rule changes almost nothing. In the sweep of its misleading characterization of what the SEC was seeking to accomplish, it leaves an informed reader amazed at the firm's audacity. It carried Fiction Number One to a breathtaking extreme. I want you to hear only one statement taken from this document. It appears twice with only slight variations. Here's one version:

> "The real issue for audit committees is the nature of the work performed, not its cost. The rules do not indicate that fees of any magnitude alone impair independence. Nor did the SEC cite specific ratios of audit to nonaudit fees as being 'good' or 'bad.'

"Historically, the size of nonaudit fees paid to an audit firm has been relevant to SEC independence considerations only to the extent that the total fees earned from one client represent a disproportionate percentage of the audit firm's total revenues. SEC guidance on this point has established 15 percent of an audit firm's total fees as a threshold of concern."

In 2001, the smallest of the Big 5's total revenues was reported in *The New York Times* to have been more than $9 billion. Using the 15 percent "threshold of concern," a client could pay its Big 5 auditor at least $1.35 billion dollars per year in nonaudit fees before the audit committee, SEC, or anyone else need trouble itself over independence. In practical terms, there was no limit.

How any professional firm, let alone a closely regulated firm of auditors, could so blatantly deceive its audit clients in this way defies common sense. For me, given the spirit of what the SEC was trying to accomplish by this rulemaking, and the take-no-prisoners approach of the profession, the only plausible answer is that it is a reflection of the contempt that a victor sometimes directs against the vanquished. For there was no question that the firms were victorious in beating back the SEC's efforts at reform.

The Big 5 firm that authored this statement surely knew that the 15 percent "threshold" came out of a 1994 no-action position taken by the Office of the Chief Accountant to address nonaudit fees proposed to be paid to a very small auditor to allow that auditor to take on as a client its first SEC registrant. They know as well that this ruling was limited to its special facts and contained no suggestion of being an authoritative statement with regard to independence generally.

One basic problem with nonaudit fees, which exists regardless of their magnitude but grows more serious as the fees grow larger, is conflict of interest. This conflict derives from the fact that, in performing both audit and nonaudit services, the audit firm is serving two different sets of clients:

1. *Management,* in the case of nonaudit services, which typically are commissioned by, and performed for, management.
2. *The audit committee,* in the case of audit services, which now are by rule commissioned by the audit committee and performed for that committee, the shareholders and all those who rely on the audited financials and the firm's opinion in deciding whether to invest.

The audit firm is a fiduciary in respect to each of these two very distinct client groups, duty-bound to serve each with undivided loyalty. It is obvious, and a matter of common experience, that in serving these different clients the firm will be regularly subject to conflicts of interest. These conflicts tear at the heart of independence. What is independence? It is the absolute freedom to exercise undivided loyalty to the audit committee and the investing public. When other loyalties tug for recognition, and especially when they come from those in a position to enlarge or shrink one's book of business, on which depends one's partnership share, the freedom necessary to meet one's professional responsibilities as an auditor is adversely affected.

Paul Volcker, in testimony on the rule, given in New York City on September 13, 2000, made the same point:

"The extent to which the conflict has in practice actually distorted auditing practice is contested. And surely, instances of overt and flagrant violations of auditing standards in return for contractual favors—an auditing capital offense so to speak—must be rare. But more insidious, hard-to-pin down, not clearly articulated or even consciously realized, influences on audit practices are another matter."

To highlight the size of the hole in the rule, consider that, in addressing disqualifying financial and business relationships between an accountant and its audit client, the rule declares in absolute terms that an audit firm lacks independence if there exists (a) any investment in the client, however small, by the firm or personnel involved in the audit, or (b) any direct business relationship with that client, however insignificant. Explicitly excluded from the term "business relationships," is the provision of nonaudit services by the audit firm to its audit clients. Thus, one faces the absurdity of a rule that is absolute in banning financial and business relationships that are utterly inconsequential while appearing to allow any level of nonaudit fees to be paid to the audit firm.

My point is not to suggest that the finely textured concerns of the SEC over the independence-impairing effects of various financial and business relationships are misplaced. They reflect legitimate, albeit immeasurable, concerns. But the important point is that they pale in significance when compared to the potential for impairment that comes from the financial and business stake that an audit firm,

despite the rule, is still free to develop in an audit client through provision of a very wide variety of permitted nonaudit services.

To plug this big hole, I suggest a simple exclusionary rule covering virtually all nonaudit services, in place of the deeply complex, existing rule that I hope, by now, to have convinced you is ineffective.

This rule would define the category of services to be barred as including everything other than the work involved in performing an audit and other work that is integral to the function of the audit. In general, the touchstone for deciding whether a service other than the straight-forward audit itself should be excluded from nonaudit services is whether the service is rendered principally to the client's audit committee, acting on behalf of investors, to facilitate, or improve the quality of, the audit and the financial reporting process or is rendered principally to provide assistance to management in the performance of its duties.

This exclusionary rule could include a carefully circumscribed exception to permit certain types of nonaudit services to be rendered by the audit firm to its client where special circumstances justify so doing. Use of such an exception should require at least the following:

(a) Before any such service is rendered, a finding by the client's audit committee that special circumstances make it obvious that the best interests of the company and its shareholders will be served by retaining its audit firm to render such service and that no other vendor of such service can serve those interests as well.

(b) Forthwith upon the making of such finding, submission of a written copy thereof to the SEC and SRO having jurisdiction over the profession.

(c) In the company's next proxy statement for election of directors, disclosure of such finding by the audit committee and the amount paid and expected to be paid to the auditor for such service.

The rule would be refined, administered, and enforced by the legislatively empowered SRO that is the subject of my second recommendation for reform (discussed below).

The fundamental argument for exclusion is the avoidance of what amounts to a professional conflict of interest in serving two clients within one corporation. Beyond that, however, there are a number of other points to be made. And I summarize them below:

1. Given the conflict of interest, it is not realistic to expect the firm, itself, to decide convincingly on its own independence. Given its self-interest in the outcome, the credibility of this process is highly suspect.

2. Nor is it feasible to expect independence to be assured by approval of the audit committee. It is impossible for that committee to identify when the problem exists. To challenge the auditor's judgment on the matter is to challenge its integrity, something audit committees are not likely to do. Independence is a state of mind, necessary to maintain the skepticism and objectivity that long have been the hallmarks of the accounting profession. Being subjective and invisible, independence is not something an audit committee can apply any known litmus test to determine.

3. No one has suggested that the audit committee can be a substitute for clear rules where the problem of conflicts is most serious. Thus, for example, there is no suggestion that the audit committee be accorded discretion to assess independence despite the existence of financial or business interests between the audit firm and its client. Stock or other financial interests in one's audit client, for example, have long been viewed as creating too clear a conflict of interest to become the subject of discretion, even if exercised by an audit committee composed only of outside directors. The need for an exclusionary rule is rooted in the same ground: Prospective revenues from the provision of nonaudit services, extending into the future, create precisely the kind of financial stake that produces a conflict of interest capable of impairing independence.

4. An exclusionary rule is easy to administer. It does not preclude an audit firm from engaging directly or through affiliates in nonaudit services of any kind. All business entities other than its audit clients are available for business. Since the rule would apply to all audit firms, for each audit client put out of bounds for nonaudit services, all the clients of other audit firms become available.

5. An exclusionary rule should correct the current system of compensation, which was found by the Panel on Audit Effectiveness to fail in giving adequate weight to performing the audit function with high levels of skill and professionalism. This situation adversely affects audit effectiveness. Success in cross-marketing an audit firm's consulting services is a significant factor in the compensation system. The skills that make one successful in marketing nonaudit services to management are not generally consistent with the professional demands on an auditor to be persist-

ently skeptical, cautious, and questioning in regard to management's financial representations. As long as the marketing of nonaudit services by auditors to their audit clients is encouraged, expected, and rewarded, there will exist a tension counterproductive to audit excellence. An exclusionary rule would eliminate both this tension and its harmful effects.

6. An exclusionary rule would be effective in rewarding those audit firms most sensitive to the independence issue and most scrupulous in seeking to avoid a real problem or even the appearance of a problem. Toothless exhortation and disclosure are pale green lights to those willing to sail close to the line, or cross over it. This situation has the perverse impact of hurting the competitive position of the most sensitive and scrupulous audit firms, and in time encourages even those firms to drop their guard and exploit the laxness in standards as well.

7. Independence is given important meaning in many analogous situations where potential conflicts, while not always certain to impair independence, nonetheless are prohibited in the interest of avoiding the problem. For example, consider the kind of independence necessary for a director to serve on an audit committee of a public corporation. The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees determined that, for a director to be independent for that purpose, he or she must not accept compensation from the corporation for any service other than service as a director and committee member. The Blue Ribbon Committee noted that ". . . common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control, and reporting practices." The common sense parallel to the auditor is both exact and compelling. Compensation for any service other than the audit threatens independence.

8. An exclusionary rule is a low-cost premium on an important insurance policy for the whole profession, against governmental intervention to deny audit firms the right to do any nonaudit work. In the Panel's Report we wrote, as of August 31, 2000, that "an exclusionary rule would go far toward eliminating the possibility of a major audit failure being linked to the influence of nonaudit service business on the audit firm's diligence and skepticism, an event that would provide a basis, and possibly the momentum, for some radical solution like a total ban." Enron could turn out to be the failure we were imagining.

The Need for a Legislatively Empowered Self-Regulatory Organization

The second fiction I wish to address is the profession's three-fold claim that (1) it has the ability and motivation to regulate itself voluntarily, (2) it has done so effectively over the past several decades, and (3) therefore, there is no need for a legislatively empowered regulatory body led by persons independent of the profession.

The present form of self-regulation of the auditing profession reminds one of military music, or even, some might argue, corporate governance—a classic oxymoron. Having looked closely at the system of governance within the auditing profession, I am not prepared to be quite so simplistic. However, I am quite certain that the governance of this vitally important profession is in an entirely unsatisfactory state. Moreover, this is no trivial matter.

Overview of Governance

Today, governance is exercised from three sources:

1. State boards of accountancy, which have licensing powers.
2. The SEC, which exercises potentially broad powers over those who audit reporting issuers.
3. Private organizations of the profession, of which there are at least seven important ones.

The profession claims that, through its various organizations, effective self-regulation is achieved. Having looked closely at this claim, I believe it to be false. What one sees is a bewildering maze of overlapping committees, panels and boards piled one on top of the other. They are characterized by complexity and ineffectiveness in matters of central importance to any effective system of self-regulation.

Among the short-comings of the present system are the following:

1. Lack of real public representation.
2. Lack of unified leadership over the seven organizations.
3. Lack of transparency.
4. Fuzzy and often overlapping areas of responsibility.
5. Conflict between self-interest (as in the American Institute of Certified Public Accountants, AICPA, which is a trade organization parading as an SRO) and protection of the public interest.

6. Lack of any credible system for imposing discipline, a *sine qua non* for effectiveness.
7. Lack of assured funding.
8. Overall, lack of accountability to anyone.

Given its importance, a further word on discipline. Here's all there is. The Quality Control Inquiry Committee of the SEC Practice Section of the AICPA (QCIC) is charged with investigating alleged audit failures involving SEC clients arising from litigation or regulatory investigations. However, it is only looking to see if there are deficiencies in the firm's system of quality control. It is not involved in assessing guilt, innocence, or liability of the firm or any individual. And its report is only prospective in its impact.

The Professional Ethics Executive Committee of the AICPA (PEEC) is charged with such responsibility for discipline as exists. It is supposed to pick up cases from the QCIC. However, out of alleged "fairness," at the firm's request, the PEEC will automatically defer investigation until any litigation or regulatory proceeding has been completed, often many years later. This system results in long delays in investigation and, as a practical matter, renders the disciplinary function a nullity in almost all instances.

It was the Panel's hope to recast the POB as the central overseer of self-regulation, with power and with responsibility to effect changes necessary to make self-regulation effective. With a new and energetic Chairman in Chuck Bowsher, this idea seemed achievable. As conceived by the Panel, the POB would have had these new elements:

1. Public members, independent of both the profession and the SEC, would constitute a majority of the board.
2. "Strings attached" funding would be provided by the profession in amounts sufficient to carry out the POB's mission.
3. Absolute control over the nature of its work and the budget necessary to carry out that work.
4. Power to oversee all of the profession's governance organizations.
5. Power of approval over appointments to the various organizations and over hiring, compensation, evaluation, and promotion decisions by AICPA in respect of employees of key organizations.
6. Term limits for board members.
7. Nominating committee for selection of board members, composed of representatives of public and private institutions especially concerned with the quality of auditing and financial reporting.
8. Advisory council, composed similarly to the nominating committee, responsible for annually reviewing the work agenda for the POB.

The new charter for the POB was the result of heavy negotiation among the Big 5, the AICPA, and the SEC. It fell short of the Panel's recommendations in several important respects:

1. No POB approval over membership of governance organizations. Concurrence rights over Chairs.
2. No oversight over PEEC's standard setting activities.
3. No nominating committee or transparency for POB board membership.
4. No oversight of staff of key governance organizations.
5. No power to change POB charter.

The POB believed it could work around its charter limitations by the threat of going public with disagreements. A whistle-blower technique. At the time I thought this a slim possibility. Making the POB the central, responsible, and empowered regulator of the profession, which was the Panel's goal and similarly the goal of the SEC under Chairman Levitt, was powerfully and effectively resisted by the AICPA. Again, the battle was waged. Again, the AICPA and the big firms asserted their immense power on behalf of unchecked self-interest. And again, the profession's leaders came out on top.

However well-intentioned Chuck Bowsher and his board might have been, and I know they were well-intentioned, there was no way they could have achieved effective self-regulation of this profession under the POB's charter as negotiated in 2000. Even if they had gotten all that the Panel advocated, it wouldn't have worked. The reason is quite simple. Like many other businesses, the profession, and particularly its current leaders, apart from the POB, do not want self-regulation. They want the shield of apparent self-regulation. But not anything close to the real thing.

Now, as you know, the POB members have all resigned in protest over the actions taken by the Big 5 CEO's and the AICPA, in cooperation with the new SEC Chairman and in complete disregard of the Panel's recommendations and the modest ef-

forts taken so recently to strengthen the POB. The five members of the POB did, indeed, become whistle-blowers, having no other choice even in the face of a palpable crisis to the profession.

Whatever the explanation for the profession's nearly suicidal attempt to evade the POB, which was the only plausible entity capable of some self-regulation, and whatever the SEC Chairman's motives in lending support to this effort, it will not stand scrutiny. On the back of Enron, real reform must come at the legislative level. It must emerge from the lawmakers on Capitol Hill not only because the SEC appears unwilling to lead. In regard to an SRO, only legislation can arm an SRO with the necessary powers to do the job. A review of the essential elements common to all the existing SRO's will explain why this is so. Here they are:

1. Creation by legislation or by governmental agency pursuant to legislation, with clear powers to write rules and conduct enforcement and disciplinary proceedings.
2. Supervision by Government agency, including registration with that agency to operate as an SRO, agency approval of all rules adopted by the SRO and agency power to adopt rules for the SRO.
3. Power in the supervising agency to sanction the SRO for failure to perform its responsibilities, as, for example, failure to comply with its self-governance rules or to enforce the rules it imposes on those it has the chartered duty to regulate.
4. Requirement that all participants in the profession or industry being regulated (that is, brokers and dealers) become subject to the SRO's jurisdiction and powers.

It will be useful to examine further the workings of the NASD's SRO, whose most important public duty is that of policing the rules of financial responsibility, professional conduct and technical proficiency. In carrying out this charge, the SRO is given essentially the same range of sanctions available to the SEC, which must be applied by the SRO in cases where a broker-dealer or its employees have violated the securities laws or SEC-enacted rules or the rules of the SRO. Of particular importance in achieving wide-spread compliance with the rules of professional conduct is the power of both the SEC and the SRO to discipline either or both the supervisory personnel and the firm for a failure to supervise employees who misbehave. To avoid sanction the firm must have in place procedures to deter and detect rule violations and a system for the effective implementation of those procedures. It is hard to exaggerate the importance of this "duty to supervise" in respect of its prophylactic effects.

To facilitate speedy investigation by the SRO of alleged violations, and speedy judgment and imposition of sanctions where warranted, the SRO has one critically important tool that it uses to gain the cooperation of those it regulates, even those who are targets of an investigation. Its rules require each of its registered firms and individuals to turn over all requested documents and other information, and to appear and testify, in connection with an SRO investigation. Failure to cooperate in this way can result in expulsion from the industry. Courts have held the Fifth Amendment privilege against self-incrimination inapplicable to sanctions imposed by an SRO. Thus, as a practical matter, those regulated by the SRO, including the target of an investigation, must cooperate or lose their right to be in the industry.

As a result of being vested with law enforcement powers in combination with close supervision from a governmental agency, an SRO possesses three significant protections that typically are only enjoyed by governmental agencies in the exercise of enforcement powers. They are:

1. Immunity from suit.
2. Privilege from discovery of investigative files. It is important to note here that this privilege is generally understood to operate only during the investigation. This limitation holds for the SEC too.
3. Protection from antitrust violation for group boycott or other activity violative of antitrust principles.

These protections proceed from the fact, as reflected in Congressional committee reports, that an SRO is delegated law enforcement powers subject to supervision by the governmental agency from whence those powers came. Effectiveness compels the delegation of these protections as well.

From the foregoing brief summary of the common elements of an SRO, it can be seen that a private organization such as the POB, voluntarily organized by the accounting profession to self-regulate itself, cannot do the job, no matter how well-intentioned its leaders might be.

To reiterate: The SRO's are effective because they are accountable to a governmental agency and derive from their relationship with that agency immunity from suit and important protections against discovery and antitrust laws, while at the

same time preserving their private status enough to avoid the Fifth Amendment's protections for those it regulates.

The inescapable conclusion from this analysis is that, unless and until a real, legislatively supported SRO is put in place to regulate the accounting profession, little, if any, progress toward an effective disciplinary system for accountants practicing before the SEC can be made, outside the SEC itself.

The need for the two reforms outlined above is not a trivial matter. To the contrary. I will use an analogue from Congressional history to measure this need. In the wake of the Great Depression, with the failure of an immense number of banks, and the huge losses to depositors, the Congress recognized that the public's confidence in the country's banking system had been badly shaken. Through hearings before the House and Senate, it became clear that the public's earnings, when deposited in banks, had to be made safe, in fact, and the public had to be convinced of their safety. To meet this goal Congress passed the Banking Act of 1933, creating the Federal Deposit Insurance Corporation and the system of deposit insurance we still enjoy.

Since 1933, as you all know, the public's earnings have gradually migrated from the banking system to the capital markets: From bank deposits to money market mutual funds and, increasingly, to equities.

With this shift in how the public saves its earnings must come a shift by lawmakers in fashioning the kinds of protections these public investors need.

The Congress should not, of course, create a safety net to protect public investors in equities against any loss. To do that would be to do more harm to our system of capital formation than good.

But the Congress should act to insure that the system by which our corporations present their financial condition to the world is worthy of trust by the investing public. The auditors are the last line of defense against management's inclination to fudge the numbers and, in recent years, with disturbing frequency, to present misleading and even false numbers.

Legislative action is needed now, because, with the growing number of audit failures in recent years, culminating (but not ending) with Enron, the public's trust and confidence has again been badly shaken, just as in the Depression. However, this time the loss of confidence is by the public in its capacity as investors, not depositors, and its loss of trust and of confidence is directed at the reliability of financial statements certified by auditors.

I hope that the Enron hearings will convince Congress that the public's trust in the auditing system must be restored by prompt and forceful legislative intervention, just as the public's trust in the banking system was restored by forceful Congressional action in 1933.

The two reforms I have summarized will do the job. Other measures addressed to: (1) matters of corporate governance, such as assuring punishment of officers and directors for dereliction of duty or conflict of interest; or (2) matters of conflict of interest involving securities analysts, may prove useful if carefully drafted after study and a weighing of costs against benefits. The time for reforming the auditing profession, however, is here and now.

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510–6075

March 6, 2002

The Honorable George W. Bush
President
1600 Pennsylvania Avenue, NW
Washington, DC 20500

Dear Mr. President:

Yesterday the Committee on Banking, Housing, and Urban Affairs received a report from the United States General Accounting Office (GAO) examining operations at the Securities and Exchange Commission (SEC). The GAO concluded that the SEC's dual responsibility to protect investors and assure the integrity of the securities markets may be threatened by the inadequacy of its staff resources. Given the immediacy of this risk and its potential consequences for our capital markets and therefore our national economy, I urge you to take prompt action to assure additional resources for the SEC with a supplemental appropriation for fiscal year 2002.

I am deeply concerned that the Administration appears not to appreciate fully the role of the SEC in ensuring investor confidence, on which the efficient functioning of our capital markets ultimately depends. Recent statements by a spokesperson for the Office of Management and Budget suggest that the Administration sees the Commission's budget as secondary to other government priorities. In fact, however, healthy capital markets are essential to preserving our national economic strength, which surely must be one of our top priorities.

The circumstances surrounding the recent failures of Enron Corp. and other public companies have raised especially urgent questions because, for the first time in our nation's history, a majority of Americans are now investors, directly or indirectly. As they make the financial decisions that shape their lives and assure their families' well-being, they must have confidence that the information available to them is complete, accurate, timely, and comprehensive. Investor confidence, and accordingly the strength of our markets, requires the SEC to address investor protection, accounting, market regulation, and other complex issues raised by the Enron experience.

In its report the GAO concluded that "recent disclosure and accounting scandals illustrate how important it is that SEC rise to the challenge of providing effective market oversight to help maintain investor confidence in securities markets." At the same time, the GAO found that the Commission's budget resources have not kept pace with the growth in the markets. For example, between 1991 and 2000, the number of enforcement staff devoted to investigations increased only 16 percent, while the number of cases opened during that period increased 65 percent.

Moreover, limited staff resources have prevented the SEC from reaching its goal of reviewing 30 to 35 percent of annual corporate filings; in 2001, the SEC reviewed only about 16 percent of annual corporate filings. In the SEC's formal budget estimate, it frankly acknowledges that it will fail to meet one of its inspection goals.

The GAO also noted that high staff turnover threatens to undermine the Commission's work. In 2001, turnover at the SEC was almost twice the government-wide rate. The Congress has worked to remedy this problem by providing the SEC with the authority to pay its employees on a par with the employees of the Federal banking regulators. I recently joined you at a White House ceremony where you signed H.R. 1088, the "Investor and Capital Markets Fee Relief Act," which included a pay parity provision in addition to reducing the fees charged by the SEC. The Commission lacks the funds to implement the pay parity program, although the FY03 budget submission fully implements the fee reduction program. I urge you to redress this imbalance in the supplemental appropriation.

In addition to the GAO report, I commend to you the record of the Senate Banking Committee's hearing on February 12, 2002, the first in a series of oversight hearings on the topic of "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies." The witnesses at that hearing were five former SEC Chairmen: Roderick M. Hills, Harold M. Williams, David Ruder, Richard C. Breeden, and Arthur Levitt. They represented both parties and five administrations – three Republican, two Democratic. These former Chairmen were unanimous in the view that the SEC urgently needs additional resources if it is to carry out its mission.

Given the magnitude and the urgency of the challenge facing the SEC, I urge you to request a supplemental appropriation to assure timely and equitable implementation of the pay parity provisions which you have signed into law, as well as necessary additional staff resources for the Commission. Former Commissioner Bevis Longstreth, who served in President Reagan's first Administration, once described the Commission as "a jewel among government agencies." It has never been more important than it is today for the Commission to maintain that high standard.

Sincerely,

Paul Sarbanes

Paul S. Sarbanes
Chairman

cc: The Honorable Mitchell E. Daniels, Jr.

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March 22, 2002

U.S Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Chairman Sarbanes, Ranking Member Gramm
and Other Distinguished Members of the Committee:

The National Association of State Boards of Accountancy appreciates the opportunity to share with the Committee some concerns about the changes in regulation of accountants proposed in the legislation spawned by the recent collapse of Enron. This financial tragedy has clearly shown the pivotal role certified public accountants play in the marketplace. We have seen, if the public's trust and confidence in the CPA's report is shattered, the market responds adversely, negatively impacting investors, employees and corporations both domestic and foreign. Those consequences are pervasive, affecting all audited entities throughout our market system -- not just SEC registrants.

In recent weeks, many Federal legislators, as well as the Securities and Exchange Commission, have proposed legislation and rules aimed at strengthening the regulatory system that governs accountants who audit reports submitted to the Securities and Exchange Commission. The state boards welcome changes that would enhance public protection, but there are some proposed changes that deserve additional consideration because of their impact on all businesses, small as well as large.

Background

For over 100 years state accountancy boards have been issuing licenses to "certified public accountants" who have shown they are competent to apply professional standards. This nation's 54 boards of accountancy (including all states, the District of Columbia, Guam, Puerto Rico and the Virgin Islands) currently license over 550,000 certified public accountants. It is the boards' job to license only those candidates who meet education, examination and experience requirements. Once licensed, they must periodically meet continuing professional education requirements. Firms in more than half of the states must also undergo practice review to be registered to offer accounting services to the public. State boards of accountancy are additionally responsible for disciplinary actions against CPAs and CPA firms. When appropriate, these actions result in the limitation, suspension or revocation of licenses to practice. Revocation is the true "death penalty" for individual CPAs and firms, not only in respect to their practice before the SEC, but also in offering accounting services to the public.

State accountancy board members are accountants and public members who are appointed by their governors. Though many CPAs serve on boards, those boards are part of state government and are not affiliated with any professional association, neither the American Institute of CPAs, National Society of Accountants, National Council of CPA Practitioners nor any of the other organizations that represent the profession. Board members are charged with protecting the public and it is in meeting this responsibility that the recent legislative proposals can significantly help them.

Looking Ahead

Specifically, there are seven areas that the new legislation needs to consider:

1 - Will the state licensing system continue to be used as the basis for recognition of professional competence? In the legislation proposed to date, licensure appears to be maintained as a precondition for registration, but several proposals expressly require the firms to list their affiliated persons and their state license numbers.

2 - Would there be procedurally the possibility of cooperative enforcement with the new regulatory oversight board? This could be achieved via a mechanism by which one or more state boards could intervene, allowing joint hearings to be held.

3 - Will the new board make the documents uncovered in its investigations available to other Federal and state enforcement agencies, including the state boards of accountancy? States should have access to the documents collected regardless of the results of the investigations. Despite the state boards' own strict confidentiality standards, they presently have difficulty in gaining access to the SEC's materials.

4 - Will the new regulatory oversight board be given the authority of the SEC and will the new board follow due process hearing procedures that will enable the state boards to discipline on the basis of the new board's findings? State boards can discipline licensees based on SEC discipline without conducting hearings on the underlying facts, which saves enormous amounts of investigative costs. State boards operate on a complaint-based system. Once a complaint is received, an investigation is started to determine if there is sufficient evidence to move forward with discipline. Findings against a licensee already afforded a hearing hastens the process.

5 - Will the individual state boards be notified directly of the new board's disciplinary findings so that prompt action can be taken relative to licenses?

6 - Will the state boards of accountancy be represented on the new board or on those joint bodies determining standards of professional conduct? Such representation could provide practical assistance in coordinating standards for all licensees.

7- Will the reports of the mandated quality review system be made available to the state boards so that they can take appropriate follow-up measures? In some states, the boards are only notified that the registrant has undergone a peer review. Rarely are they informed of modified or adverse peer review reports being issued.

Three Questions from the Committee's Staff

Based on the testimony already heard by the Senate Committee on Banking, Housing and Urban Affairs, the staff has specifically requested answers to three questions:

1 - Clarify what is being requested when sharing of information is discussed.

When the new oversight board institutes an investigation, it should notify the state licensing boards in the states in which the public accounting firm or person associated with such firm engaged in the act or the failure to act alleged to have violated professional standards, of the pendency of the investigation, and shall invite the state licensing boards to participate in the investigation (as proposed in Congressman Lafalce's HR 3818).

Then, as identified in Congressman Dingell's HR 3970, the state boards, as investigating bodies, would want to have available to them all reports, memorandums and other information prepared or received by, and deliberations of, the new oversight board and its employees and agents in connection with an investigation. This information should be admissible in any action brought by a state licensing board.

2 - How is disciplinary action to be coordinated with the states?

When an individual or firm registers with the new organization, the license or certificate number of each such person issued by the appropriate state board of accountancy should be listed with the organization to facilitate communication with the state boards.

As discussed above, the board should be invited to participate in the investigation.

If the new board or the SEC imposes a sanction upon a public accounting firm or person associated with such a firm, and that determination either is not subjected to judicial review or is upheld on judicial review, the state licensing board should be able to impose a sanction on the basis of the new board's report (HR 3818).

During the required quality review for registered accountants (as stated in Senator Dodd's S. 2004), should inspection identify any act or practice or omission to act, by the registered accountant or any associated person, that the oversight board determines may be in violation of the Act, the rules of the new board or the SEC, or professional standards there shall be a "report of any such act, practice, or omission to the Commission, the Attorney General of the United States, and the appropriate state regulatory authority [state accountancy board] for appropriate referral and investigation...."

Also as stated in S. 2004, the new oversight board "may refer any investigation to the Commission, the Attorney General of the United States, and the appropriate State regulatory authority [state accountancy board], as it determines appropriate, and each such entity shall evaluate any such referral and take such action with respect to the matter referred as it determines necessary or appropriate."

3 - Why can't there be two levels of standards for accountants performing work for SEC registrants and for those who are not?

The basic problem here is creating a coherent definition of independence for the accounting profession that the public can understand and rely on. If you have a CPA who works with one client that is an SEC registrant and then for another privately-owned company, it should be clear in all cases the services exhibit compliance with professional independence. Even to the informed public, it will be very hard to explain why an audit firm cannot perform non-audit services for an SEC-registrant it audits, but can perform both audit and non-audit services for a company not registered -- and still be considered independent. Think how much more difficult that explanation will be when dealing with the many individuals who simply place their trust in the hands of state and Federal authorities.

Currently the General Accounting Office and the Securities and Exchange Commission have set different standards for independence. These differences require reconciliation to clearly define what services are permissible in a professional engagement.

It will continue to be the SEC that decides what should be the independence standard for those doing work for its registrants, but it will fall to the state boards to figure out how it will affect those accountants who are not doing this work. A coherent definition is preferable, but may not be enforceable. The current jumble of independence standards (i.e., GAO, SEC, AICPA, state boards of accountancy) hasn't yet been resolved in any discussions we've heard before various Congressional committees or in any of the proposed legislation we have seen. We believe it makes sense to convene the leaders of the various constituent groups involved in overseeing adherence to independence standards for the purpose of harmonizing their rules. We had hoped that the now defunct Independence Standards Board would have made strides in achieving this goal. But the ISB's credibility suffered as a result of its ill-advised composition, which was dominated by representatives of the accounting profession and failed to include any state board representative.

Overview

The new legislation has the potential to simultaneously strengthen government oversight at both the Federal and state levels in order to maximize public protection. While we believe self-regulatory activities of the profession have been, and should continue to be, effective complements to Federal and state accountancy regulation, in no way should self-regulation be viewed as a substitute or significant mitigating factor for either. Communication and careful process design are the keys to achieving maximum protection.

CPAs have been denigrated in recent weeks for what has been alleged as the misjudgments, errors or wrongdoing of a few. Yet, overall, CPAs are people who have met tough education, examination and experience standards and are committed to career-long learning.

Until recently, CPAs were reputed to have high integrity and to demonstrate strong ethical conduct. To set up oversight boards that specifically deny committed professionals leadership roles would be a mistake and should be reconsidered. Summarily dismissing those individuals who have acquired the greatest expertise in the field seems to make little sense. When HMO's allow non-physicians to dictate medical procedures, patients have protested. Is Congress about to set up a similar situation that would permit non-accountants to oversee technical standards?

The state boards of accountancy stand behind the quality of their licensees, but the system can be improved. NASBA and the state boards have supported strong public protection in their statements to the SEC and the Public Oversight Board and have encouraged clear commonsense rulemaking for professional standards. The proposals recently put forth have the potential to enhance public protection on both the national and state level and we applaud the Committee members' efforts to find the right legislation to bring this about.

Respectfully submitted,

Barton W. Baldwin, CPA
Chair, NASBA

David A. Costello, CPA
President and CEO, NASBA

Thomas J. Sadler

Thomas J. Sadler, CPA
Chair, NASBA Litigation Response and Assistance Committee

ACCOUNTING REFORM AND INVESTOR PROTECTION

THURSDAY, MARCH 14, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

This morning, the Committee on Banking, Housing, and Urban Affairs continues its hearings on auditing, accounting, financial reporting, and investor protection.

Although much of what is happening in the Congress has been prompted by the collapse of one extremely large company, the interest here in the Committee has been in trying to fashion an effective response to what appears to be a structural and a systemic problem.

In some respects, the problem perhaps can be summed up by the simple fact that, in addition to a well-publicized series of financial failures, public companies restated their earnings 607 times in the past 3 years, more than in the entire previous decade. Against that background an objective must be to strengthen audit quality, auditor independence, financial reporting, all of which, of course, are highly relevant to investor protection. And, of course, investor protection is essential to sustain the integrity of the capital markets, which have been an important dimension of our economic strength.

Each of the country's Federal securities laws—the 1933, 1934, 1935, and 1940 Acts—requires comprehensive financial statements that must be prepared, in the words of the Securities Act of 1933, by "an independent public or certified accountant."

Professor Benjamin Graham's seminal textbook for securities analysts gives the reason:

> Prior to the SEC legislation, it was by no means unusual to encounter semi-fraudulent distortions of corporate accounts, almost always for the purpose of making the results look better than they were, and it was generally associated with some scheme of stock market manipulation in which the management was participating.

The statutory independent audit requirement which I referred to earlier, contained in the 1933 Act, has two sides to it. It grants a franchise to the Nation's public accountants, since their services, and only their services, and certification, must be secured before an

issuer of securities can go to market, have the securities listed on the Nation's stock exchanges, or comply with the reporting requirements of the securities law. But the other side of this franchise comes in return for the CPA's performance, as the Supreme Court noted some years ago, of "a 'public watchdog' function that demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust." In other words, they cannot get to market without the certification. But obviously, that puts some obligations on the people that do the certification.

The significance of that public trust was recognized from the beginning of the consideration of the Securities Act by this Committee almost 70 years ago. On April 1, 1933, Colonel A.H. Carter, the President of the New York State Society of Certified Public Accountants, and Senior Partner of the firm that was then named Deloitte, Haskins & Sells, testified before this Committee. He argued then, successfully, as it turned out, that requiring an opinion by an independent accountant as to the "correctness" of financial statements of registrants was preferable to creating a core of Government auditors at the Federal Trade Commission. He explained that independent auditors were in a different position than "corporate comptrollers," and I quote him:

> We audit the corporate comptrollers. The corporate comptroller is in the employ of the company. He is subject to the orders of his superiors. He is not independent. CPA's should be empowered to check the accounts because it is generally regarded that an independent audit of any business is a good thing.

When Senator Barkley, a Member of this Committee, asked Colonel Carter, "Who audits you?" He replied, "Our conscience."

Senator GRAMM. The best audit.

Chairman SARBANES. We have heard during these hearings from former chairmen and chief accountants of the Securities and Exchange Commission, former Federal Reserve Board Chairman Volcker, who testified as Chair of the Trustees of the International Accounting Standards Committee. We heard from the current Chair of the International Accounting Standards Board, David Tweedy, the Chair of the Financial Accounting Standards Board from 1991 to 1998, leaders of prior efforts to address accounting abuses and lagging standard setting, and experts in corporate governance. Virtually every witness has recommended basic changes in the regulation of auditing under the Federal securities law. It is appropriate, as we are doing today, that we hear from representatives of the accounting industry—not only appropriate, but also, obviously, quite important.

The American Institute of Certified Public Accountants was established in 1887, and as I understand it, now has about 350,000 members. Among its many activities, its committees promulgate auditing and ethical standards for accountants, and review claims of violation of professional ethics. The AICPA represents the interests of the accounting profession before the Congress and before the Nation's regulatory agencies.

In fact, the AICPA has itself recognized a problem. It has now posted on its website the following:

> Investor confidence, already shaken by significant volatility in the capital markets, has been further unsettled by the highly publicized restatements of financial statements, which have generated questions about the quality of financial reporting,

the effectiveness of the independent audit process, and the efficacy of corporate governance.

We, therefore, look forward today to hearing the accounting industry's recommendations for addressing this situation. And subsequent to this panel, we will hear from two economists, one from Brookings and one from AEI, who have studied various aspects of current accounting issues.

Before I introduce the witnesses for their statements this morning, I will yield to my colleagues.

Senator Gramm.

Senator GRAMM. Mr. Chairman, Senator Bunning, I understand, has a conflict. So if it is okay with you, I would let him go first.

Chairman SARBANES. Yes, it is certainly okay with me.

COMMENTS OF SENATOR JIM BUNNING

Senator BUNNING. I would like to thank you, Mr. Chairman, for holding these very important hearings and I would like to thank our witnesses for being here to testify. I would especially like to thank Senator Gramm for letting me jump ahead of him.

Unfortunately, today, I have to be in two places at once. In the Armed Services Committee, we have the Secretary of Energy before us today and I need to speak to him about some important issues, specifically about the uranium enrichment plant in Paducah, Kentucky. But I wanted to make sure that I came over to welcome our witnesses and thank all of you for testifying. I especially want to thank my fellow Kentuckian, Olivia Kirtley, for testifying today.

Olivia Kirtley is one of the most outstanding Louisville business consultants and was Vice President and CFO of Vermont American Corporation from 1991 to 2000. Vermont American is one of the largest manufacturers of power tool accessories. We are very happy that their corporate headquarters are located in Louisville, Kentucky. And I go by it every time I go to Louisville.

Olivia was also Chair of the AICPA board in 1998 and 1999. She currently serves as a member of the board of directors and chair of the audit committee of two public corporations.

God bless you.

[Laughter.]

Thank you very much for coming today and I am sorry that I will not be able to stay any longer.

Mr. Chairman, thank you for giving me the courtesy.

Chairman SARBANES. Certainly. Thank you, Senator Bunning.

Senator Gramm.

STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Well, Mr. Chairman, first of all, I want to thank you for these hearings and for the tenor of these hearings. I do not think the Congress, in general, has covered itself in glory on this issue. But I believe that you have covered yourself and this Committee in glory by having hearings that are forward-looking, that are aimed at trying to determine what we need to do to be certain that we restore investor confidence.

I look forward to working with you on the important legislation that will flow from this effort. I think it is imperative that the legislation be bipartisan. I think when we take a bill related to this

general issue to the floor of the Senate, that we will have numerous amendments. I think there is a great danger that we could do very substantial harm to the American economy in the process.

I believe if we are together on a bipartisan basis and we can unite our Committee, I think we have an opportunity to prevail with a reasoned approach that can benefit the American people and the American investor. If there has ever been an issue that should be a bipartisan issue that should not be a partisan issue, I think this is it.

Let me say to our witnesses that we appreciate you coming. This is the era where we are bashing accountants. It does take the focus off bashing politicians and I guess we should be grateful for that.

[Laughter.]

But I just want to say to set the record straight, in repeating a comment I made in the first hearing we had, if I had to trust the safety and sanctity of my wife and children to a politician, a preacher, or an accountant, drawn at random from the American population, I would choose an accountant every time.

I have a very high opinion of the men and women who practice accounting in America. I think it is very important that we not do anything that discourages the best and brightest from going into this profession. Because, ultimately, it is the quality of the person doing the job, not regulations, not laws. It ultimately comes down to the man or the woman who is making the judgment. And their judgment is absolutely critical.

Let me say also that we need to be very careful about unintended consequences, unintended consequences where we do harm rather than good, or where we do more harm than we do good.

There are two approaches to objectivity. And the one that I think is currently in fashion is let's find someone who just came in off a turnip truck that knows absolutely nothing about the subject, and let's give them responsibility because they are ignorant and they will be objective. But that creates its own series of problems. And I think in looking at structuring the governance of accounting, that these are issues that have to be discussed. I think it is imperative that we hear from people who are actually involved in the profession.

There is this increasing tendency in Washington and in politics to say that people who know something about a subject are the last people we should ever talk to, that somehow, knowledge is corrupting, that the ability to petition the Government, which is guaranteed in the Constitution, that somehow, there is something wrong and corrupting about that.

I would say the best information that I get in the legislative process comes from people who are directly involved in the industry that is going to be affected and, quite frankly, the people that represent them, the nefarious lobbyist who simply carries out a guaranteed constitutional right and performs great service to America in the process, in my opinion.

My job is to try to figure out what is right and wrong, what is special interest and what is public interest.

So these are very important hearings because this is a very important subject. We have had great hearings to this point, and I think they have enlightened us. We have heard many different

opinions as to what needs to be done, much of it conflicting. But when you are dealing with important issues like this and you are dealing with people who have been involved in it a lifetime, they are going to have differences of opinion. And I see that as healthy. I do not see that as a bad thing.

Mr. Chairman, again, thank you very much for these hearings. I look forward to hearing our witnesses.

Chairman SARBANES. Thank you very much.

Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman, and I thank all the witnesses for participating and taking the time to make these thoughtful presentations.

I think this is the seventh hearing, if I have counted this right. This has been a remarkable set of presentations by people who I think really are searching for the best answer that we can come up with to—I do not think a perceived problem—a real problem in a lot of people's minds with regard to the presentation of financial information, which is so vital to the fundamental workings of our capital markets.

I could not agree more with Senator Gramm about listening to practitioners. That is fundamental to make sure that we understand the nuances of what we are about. I also think this needs to be a bipartisan effort so we can get to an answer that works.

I will disagree in the sense that unintended consequences sometimes do harm. But sometimes consequences of doing nothing also create harm. If we somehow undermine the value of one's ability to analyze how companies are actually performing and there is not a sense of confidence in that, then the risk premiums that will come into the valuation process I think can be dangerous for the economy and, in the long run, the formation of capital, which I think is what our objective is, is to try to get as even and level a playing field as we can in that proposition.

I look forward to hearing all of your testimonies with it. I understand that Mr. Gerson is from Floren Park and I welcome him, a good part of New Jersey, very near to my home.

I also would say that I have had personal experiences working with the accounting industry, diligent and fair-minded individuals who have worked very hard to make, I think, the presentation of numbers that I used to sign off on ones that I felt comfortable dealing with.

So, I hope that we can look at this as a positive, integrated, and enhancing process as opposed to one that is confrontational.

Thank you very much, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Corzine.

Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman. I also appreciate your conducting these hearings and having as many hearings as we have had so that we can get as much information as possible before we leap off the ledge with legislation.

I do hope that people understand that the main reason that accounting and accountants are our focus here is because that is the jurisdiction of the Committee. And it is also an easy target.

It is a profession that has been respected and is respected and it occurred to me that maybe the reason that CEO's and CFO's and lawyers, stock analysts, and other people are not getting the same kind of scrutiny that accounting firms are getting is because there is not that same respect or expectation for those other groups.

I was very disappointed in *The Wall Street Journal* this morning. It has an article that says: How Accounting Fell From the Heights of Respectability. I did not feel quite so bad when I found out the total length of it was about five columns and it starts in 1494.

[Laughter.]

So while there have been some bad things, you have to go back a long ways to get a lot of information.

It has been one of those areas of stability and provides stability in an international market. It is very important that we do not destroy that ability as we undertake some of these operations that fall under one of the legislative principles that I noted a long time ago when I was in the legislature.

That is, if it is worth publicity, it is worth reacting to. And if it is worth reacting to, it is worth over-reacting to.

[Laughter.]

And that is where a lot of legislation goes. We do need to be very careful with this so that we do not destroy an industry that only has about five columns of bad stuff on it since 1494.

Enron and Global Crossing have raised the profile of accounting and auditing issues. The collapse of these two companies has caused a ripple of fear throughout the investing community. Investors are now asking, can I trust the officers of the company in which I invest? And can I believe the financial statements that I rely on to make my investing decisions?

For decades, our investing structure has relied on integrity as one of the cornerstones of our financial markets. If we do not restore that integrity, investor confidence will remain low and will encounter the risk of completely undermining our capital-raising process.

At this point, I think that we know a number of areas where legislation might be needed. A new board should handle the tough ethical and certain disciplinary actions dealing with bad actors. This oversight board needs the authority and manpower to catch people engaged in unethical or illegal behavior early.

You have to have registration with the board. The oversight board would have a track record of an individual accountant's performance. Therefore, public accountants should register with the board. This will allow for better coordination between enforcement agencies.

A new funding mechanism is badly needed. A board which sets our Nation's accounting principles has an enormous impact on our capital markets. The board should not have to spend time and resources looking for funding.

New disclosure requirements for corporate officers. We should no longer let corporate insiders with detailed knowledge of the com-

pany's financial position sell blocks of stock while the rank-and-file employees lose their life savings.

More accurate disclosure of companies' financial standing is also needed. Through our hearings we have learned a lot about off balance sheet partnerships. While I do think there is a useful purpose for these, if they have the ability of significantly affecting the standing of a company, they should be reported.

The SEC needs to become more engaged in the oversight of how accountants are doing their job. Enron should have had their audits reviewed by the Commission on a more regular basis.

I think the Commission is doing a fine job now. They seem to be doing a review of the audits of companies which use complicated accounting techniques. There is a higher sensitivity everywhere. However, where was the Commission over the past several years while the losses and hidden debt were building with each false report that have led to these different disclosures now?

Last, and in the long term, this point may be the most important. We need to begin moving to a principle-based accounting system. Current accounting rules are too complicated and provide too much room for loopholes. Accounting rules and their explanation should not be 800 pages long. We have to make this a priority.

I know that some of my colleagues have worked on legislation which addresses some of these concerns, but we have to be careful that the legislation doesn't go too far. We have to be careful that it goes far enough. We must remember that America's accounting system is still the best in the world and we cannot disrupt that with a knee-jerk at this point in time.

Again, Mr. Chairman, I appreciate your holding the hearing. I look forward to working with you and all of my colleagues to find reasonable solutions. I hope we can come up with some bipartisan solutions that both protect investors and create effective oversight mechanism for accountants and all of the other people involved in the areas of business and finance.

I do look forward to hearing from our witnesses. Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Enzi.

Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, thank you, and I thank our witnesses. It is good to see so many of you here. Some of you I know very, very well, and I am pleased that you are going to be with us to share some thoughts this morning.

Mr. Chairman, it has been said by others, but it deserves repeating—these have been a very fine set of hearings, very well balanced, I think, over the last several weeks, as we have tried to take a look at this overall issue and its multiple parts. I think that is an important fact to remember here.

We are dealing with a multifaceted set of issues, highly complex. And the point Senator Enzi just made deserves being repeated. There can be unintended consequences of even the best intentions of legislation and proposals. I am very mindful of that. That is why this hearing is very, very important, so that we can hear from the people within the industry itself as to how this could work.

I would just say that Senators Corzine, Stabenow, Johnson, and I have worked on a proposal. I know many of you are aware of it and have seen it. I should tell you as well, and it won't come as a surprise, but actually, many of the ideas and suggestions came from the accounting industry itself as to what we might do here.

So, I look forward to the testimony, Mr. Chairman.

I want to add my voice to those who have already expressed this view. Senator Corzine, of course, brings a very special background and knowledge to this table. But his point made earlier and repeated by others is worthwhile.

There is a lot of media attention obviously to what has happened, and maybe more so today, later today with news out of the Justice Department regarding Arthur Andersen.

The accounting industry is a great industry. It has performed tremendously. We are very successful in this country economically for many reasons, not the least of which is because of the very strong accounting industry, historically.

And so, while these are difficult days, obviously, when the headlines are not just on the business sections, but the front pages of every newspaper and leading news stories across the country, I know that there are people who work for all of you, who are involved in this industry, who wonder if they made the right career choices and what their futures may hold.

We can't succeed economically and survive well without a strong accounting industry. That would be an illusion to think otherwise.

I certainly am angered, as my constituents are, as my colleagues are, over what happened with Arthur Andersen, at least in the Houston office, and maybe beyond. We do not know that yet.

I will also tell you that I am saddened somewhat to see an industry, or company, rather, with the name Arthur Andersen reach the depths it has. What an important industry or business Arthur Andersen has been. And so, for the some 90,000 people worldwide who work for Arthur Andersen, who had nothing to do with anything that happened in Houston, these are good people, hard-working people. My heart goes out to them this morning, to their families, what they had nothing to do with, and yet, their reputations and their careers have been seriously damaged by what obviously some people may have been engaged in.

So, Mr. Chairman, these have been very worthwhile hearings and I thank you for it. But I wanted to make that particular point about my appreciation for what the industry has done.

Chairman SARBANES. Thank you, Senator Dodd.

Senator Bayh.

COMMENTS OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman.

I am looking forward to hearing from our witnesses and getting the benefit of their insights about how we can strike the right balance here between transparency and reliability of information that our capital markets depend on, on the one hand, and on the other hand, not unduly or inadvertently raising the cost of accounting services to investors and businesses, the vast majority of whom are honest.

So, I thank all of you for being here. I look forward to having the benefit of your thoughts. And Mr. Chairman, I express my appreciation to you.

Chairman SARBANES. Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman, and welcome to our witnesses.

I want to first join my colleagues, Mr. Chairman, in thanking you for being a true leader on this issue and providing what I believe is the most thoughtful, comprehensive set of hearings and discussions on what has been happening and what needs to happen as it relates to the issues in front of us.

I am pleased to be joining Senator Dodd, Senator Corzine, and Senator Johnson, in the introduction of the Investor Confidence in Public Accountability Act of 2002. I certainly want to hear the comments from those who are joining us today, each of you, regarding the issues and the provisions in the bill and how we might work together.

As this Committee has investigated investor protections and the accounting industry in light of Enron and other troubled companies, time and time again, we have heard several things. We have heard about the need for an enhanced oversight mechanism for the auditing profession. We have also heard about the potential for conflicts of interest when accounting firms offer both auditing services and consulting services to the same companies. We have heard about the need for financial independence for an industry oversight board, and we have heard about the need for financial independence for the Financial Accounting Standards Board, FASB.

In addition, I think few of us would argue that the SEC has enough resources or staff right now to be able to do its job. And I think all of us would agree that increased financial disclosures and additional information about stock sales by corporate leaders benefit American investors.

These are some of the issues we address in the legislation. I am very much looking forward to hearing all of you today and clearly would join with my colleagues as well in saying that the accounting industry is an important industry in the United States and we need to address what are serious issues for many Americans right now, but we need to do it in a thoughtful, responsible way that recognizes that this is an important industry that has provided a great service to the country.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Stabenow.

Senator Miller.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. I have no opening statement, Mr. Chairman, but thank you for these hearings. They have been very useful. They have been extremely informative and I appreciate all of our witnesses being here, especially my fellow Georgian, Mr. Copeland.

Chairman SARBANES. Thank you.

We will now turn to the panel. It is my intention to start with Mr. Castellano and then just move right across the panel, and I will introduce each witness just prior to their testifying.

Mr. Castellano is the Chairman of the AICPA Board of Directors for 2001 and 2002, a Managing Partner of Rubin, Brown, Gornstein & Company in St. Louis. He has actually served in a number of positions in AICPA's private company's practices section, a member of the Financial Accounting Standards Board's small business advisory group.

We are very pleased to have you here this morning, sir. We would be happy to hear from you.

STATEMENT OF JAMES G. CASTELLANO, CPA
CHAIRMAN, BOARD OF DIRECTORS
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)
MANAGING PARTNER
RUBIN, BROWN, GORNSTEIN & COMPANY, LLP

Mr. CASTELLANO. Good morning, and thank you also, Chairman Sarbanes, Ranking Member Gramm, and other distinguished Committee Members, for permitting me to testify before you today on accounting and investor protection issues raised by the collapse of Enron.

Chairman SARBANES. I would say to each of the witnesses, we are going to include your full statements in the record. It would be helpful if you can summarize so that we will get to the question period in the morning.

[Laughter.]

Mr. CASTELLANO. We will certainly do that. Thank you, again, Mr. Chairman.

Let me say that the men and the women of the CPA profession provide a vital service to investors, analysts, and corporate stakeholders, and we have zero tolerance for those who break the rules.

The AICPA has a long history of meaningful advocacy for maintaining the highest standard of financial reporting.

CPA's are bound by a code of professional ethics that puts the public interest first. The AICPA gives the highest priority to issues where public reliance on CPA skills is most significant. Many CPA's inside companies prepare financial statements for the 17,000 or so U.S. public companies and many independent CPA's outside those companies audit those financial statements.

In cities big and small—I am from St. Louis, Missouri, as the Chairman said—there are men and women preparing those financial statements and auditing them, and they do so with the utmost of integrity and fairness. Unfortunately, it is often the case that the significant role that those CPA's play in the U.S. capital markets only gets recognized when a business fails.

Today, you will hear from a panel of professionals who represent a cross-section of the AICPA's members working for both small and large firms and in corporate governance.

Today, we will address for you: Reforms for regulating the audit profession, including auditor independence. The likely impact of reforms on the profession's ability to recruit talent and other effects of reforms on smaller companies and on accounting firms. We will

address corporate governance issues, including the role and responsibility of audit committees. Recent initiatives that we have undertaken to strengthen auditing standards.

Each of the panelists and I have submitted written testimony and we do ask that it be included in the record of today's hearing.

Enron and its aftermath have clearly shaken public confidence in the financial reporting system. It has brought us to the cusp of an historically significant moment when we need to give thoughtful and careful consideration to meaningful reform.

As Chairman of the AICPA, I am here to assure you that the AICPA will support meaningful and appropriate reforms and will continue to be both an advocate and a catalyst for necessary change. We recognize the importance for elected leaders to act responsibly in order to do what they can to prevent a business failure on the scale of Enron from happening again.

We believe the real value of any new public policy affecting our profession must be assessed by asking four basic questions. First, will it help investors make informed investment decisions? Second, will it enhance audit quality and the quality of financial reporting? Third, will it help restore confidence in the capital markets, our Nation's financial reporting system, and the accounting profession itself? And fourth, will it be good for America's financial markets and economic growth?

Using these four criteria as benchmarks, the AICPA will work with this Committee, the Congress, the SEC, and the FASB to continue to develop meaningful and appropriate reform.

From our perspective, there are four initiatives that clearly pass the test, and strike an appropriate balance between the need for Government oversight and the efficiency of the private sector. We will firmly support the Congress and the SEC in enacting these proposals. They are:

First, we support creating a new private sector regulatory body. We believe the time is right to create new systems for performing quality reviews of the practices of public company auditors and for disciplining those auditors. Accordingly, we support moving from public oversight to public participation, and from self-regulation to public regulation of those very important processes. And we further believe that these processes should be subject to SEC oversight.

Second, we support reforming the financial reporting process. Economic change has moved more swiftly than accounting has adapted. The annual and quarterly reporting regime must keep pace with that change through more timely and broader reporting. Ultimately, we must move toward real-time disclosure.

With intellectual capital as the greatest engine for corporate growth, financial reports should include a broader bandwidth of information. Investors should know more about company plans, risks and uncertainties, opportunities and the drivers of future success. Reforming the financial reporting process clearly passes the public interest test.

Third, we support new rules for corporate governance. The SEC already has solid ground rules for audit committees. But we think the audit committee rules can be strengthened. Audit committee members should have auditing, accounting and financial expertise. Periodically, audit committees should hold separate executive ses-

sions with management, the independent auditor, and the internal auditors. We also believe the audit committee should be involved in hiring and firing the independent auditor.

And fourth, support for corporate truthfulness. We say, simply, make it a felony for anyone in a company, or anyone else involved in the financial reporting process, to lie to an auditor.

Earlier, I identified four basic questions that we suggest be used to evaluate new public policies. In that vein, we are confident that reforms can be implemented, that will improve financial reporting, increase investor confidence, and strengthen our capital markets.

We really appreciate the opportunity to be here today and we look forward to participating in this healthy debate in the days and weeks ahead.

Chairman SARBANES. Thank you very much, sir.

Now, we will turn to James Copeland, who is the CEO of Deloitte & Touche. As I mentioned earlier, I quoted from Colonel Carter, who was one of the principals in this firm many years ago.

Mr. Copeland has been with that firm or one of its predecessors since 1967. He is on the nominating committee of the International Accounting Standards Committee.

Mr. Copeland, it has become a practice in this Committee now, with Senator Miller's addition here, to especially recognize graduates or products of the State university system of the State of Georgia.

[Laughter.]

So since you are a graduate of Georgia State University, I want to underscore that fact.

Mr. COPELAND. Thank you.

Chairman SARBANES. We would be happy to hear from you this morning.

STATEMENT OF JAMES E. COPELAND, JR., CPA CHIEF EXECUTIVE OFFICER, DELOITTE & TOUCHE, LLP

Mr. COPELAND. Thank you very much, Mr. Chairman, and the other Senators.

I am appearing here today not only in my capacity as the Chief Executive Officer of Deloitte & Touche, LLP, but also on behalf of the American Institute of CPA's. I am a member of the AICPA, and Deloitte & Touche is proud to be a member of the AICPA's SEC Practice Section.

We at Deloitte have the same perspective as the AICPA and as our colleagues in the profession with respect to the many proposals currently under consideration. So, my remarks today are not solely intended to provide the Committee with Deloitte's perspective.

People are suffering because of the recent events at Enron and Andersen. As Senator Dodd said, much has been lost in this process—tens of thousands of jobs, hundreds of millions of dollars in savings for retirement, tens of billions of dollars in shareholder value, and the reputation of Andersen, one of the icons of our profession. But as sad as all of this is, there is an even more important casualty, and that is the confidence of the American investing public. We need to find out exactly what did happen at Enron and we need to fix it.

In the wake of Enron's collapse, public attention has focused on ways to improve the effectiveness and the independence of audits of public companies. And I want to make it clear that that attention is welcome.

However, the current situation presents danger, as well as opportunity. The danger is this: In the rush to enact reforms in response to perceived flaws in the system, we risk losing sight of the fact that the proposed reforms come with real consequences—intended and unintended—some of which will diminish the stability and the certainty that characterize our markets, and that permit them to be the engines of economic growth for our country. That is why we must think through the consequences of the proposals currently under consideration before we begin implementing sweeping change.

The SEC has proposed the creation of a new regulatory organization, under its oversight. We believe the time is right to create a new body, dominated by individuals from outside the accounting profession, that would be empowered to perform quality reviews of the practices of public company auditors and to discipline those auditors. Accordingly, we support moving from a system of self-regulation to one of public regulation for these important processes.

While my colleagues and I support a number of proposals that have surfaced, I would like to offer a view on three proposals which at first glance may seem to address problems of perception, but will not improve the quality of audits, nor enhance investor protection.

One proposal currently being debated is the periodic rotation of audit firms. The AICPA already requires that lead audit partners on every public audit be rotated at least once every 7 years, and this approach ensures a fresh look at a company's books at regular intervals. There is strong evidence that requiring the rotation of entire firms is a prescription for audit failure. It would result in the destruction of vast stores of institutional knowledge and guarantee that auditors would be climbing a steep learning curve on a regular basis. It would expose the public to a greater and more frequent risk of audit failure. It would increase the likelihood of undetected fraud by management. It would make it easier for reckless management to mislead the auditor. And finally, it would allow companies to disguise opinion shopping by enabling them to portray a voluntary change in auditors as obligatory.

This is not just my opinion. Many groups have studied this issue over many years and all have concluded that audit firm rotation is a very bad idea. I have cited five of these studies in my written comments.

A related proposal involves a ban on the so-called "revolving door" situations in which an auditor goes to work for an audit client. The SEC and the Independence Standards Board considered the wisdom of imposing a cooling-off period before an auditor could accept employment with an audit client, and both concluded that such a rule would impose unwarranted costs on the public, the client, and the profession. Indeed, limiting the career opportunities of accountants would make the profession less attractive and make it more difficult for firms to hire qualified people. Studies have shown, and our experience is that existing safeguards, including

the mandatory rotation of audit partners, are effective in addressing the "revolving door" situations.

That said, I do agree that the audit committee and our profession can enhance safeguards in this area to provide greater comfort to the investing public.

Another proposal currently being debated involves placing increased limitations on the scope of services that firms may provide to their audit clients. Just last month, my firm announced that we will further separate our management consulting practice—a step we took very reluctantly, but one we deemed necessary to address the market's concerns about the perception of auditor independence and to help restore investor confidence in the profession. While we have adopted this business model, but it may not be right for all other firms.

Further limiting the scope of services that firms may provide to their audit clients is a bad idea. It is a bad idea because it will not make an audit team any more independent, but it will make the team less competent.

In conducting an audit of the financial statements of a company, you obviously need good accountants and auditors, but you also need specialized technical experts. For example, in auditing a company like Enron, you would need experts in market trading controls and information technology, among others. An audit team that does not bring with it the technical knowledge and skills necessary to understand the company's business will not be able to perform a competent audit.

Why would additional limitations on the scope of services make it more difficult to bring specialists into the auditing process? Because these experts are not auditors. They do not devote their career to audit support work. And if we ask them to abandon their consulting work and do nothing but audit support work, we would not be able to retain them. The best and the brightest seek positions that will allow them to develop their expertise, to learn, to work and on cutting-edge issues and few will choose to remain in jobs that offer limited opportunities and seriously restrict their professional development and employment options.

I would add that several recent studies have demonstrated that there is no correlation between the provision of nonaudit services and audit failures, and I have provided some examples of those in my written testimony.

The current search for solutions for ways to prevent another Enron is fitting and proper. The failures of American businesses often teach us more than our successes. We should learn from what has happened and we should make changes that provide meaningful opportunity for improving the quality of audits.

Thank you very much.

Chairman SARBANES. Thank you very much, sir.

Now, we will turn to William Balhoff, Chairman of the Institute's Public Company Practice Section. Mr. Balhoff is a Senior Audit Director with Postlethwaite & Netterville, a Baton Rouge, Louisiana firm. Actually, I think the largest independent accounting consulting firm in Louisiana, as I am told.

Mr. BALHOFF. That is correct.

Chairman SARBANES. We are pleased to have you here, sir.

**STATEMENT OF WILLIAM E. BALHOFF, CPA, CFE
CHAIRMAN, EXECUTIVE COMMITTEE
AICPA PUBLIC COMPANY PRACTICE SECTION
SENIOR AUDIT DIRECTOR
POSTLETHWAITE & NETTERVILLE, A.P.A.C**

Mr. BALHOFF. Thank you very much and good morning.

In my role as Chair of the senior AICPA committee that represents the interests of smaller CPA firms, and also as a partner at a local firm in Louisiana, I am here today to represent the opinions of those small firms and the small business clients that they serve across the United States.

I have two topics that I would like to discuss with you. The first is how restricting the performance of nonaudit services would impact small business owners and our ability to meet their diverse needs. And second, how any new legislation that would affect the accounting profession must take into account its effect on the ability of accounting firms to recruit new talent.

My firm performs over 150 financial statement audits of which only three are public registrants. However, the majority of small- and medium-sized CPA firms do not audit any public companies at all. I believe that it would be a grave mistake for the Members of this Committee to believe that it is possible to impose restrictions only on the largest of firms.

History shows that new legislation by Congress is highly likely to become a template for parallel legislative or rules changes at the Federal and State levels that would directly affect small CPA firms and the small business clients we serve. In particular, as auditors who provide services to small businesses, we are often subject to rules established by State accountancy boards, the U.S. Department of Labor, the General Accounting Office, and State and Federal bank regulators. These bodies traditionally follow the lead set by Congress and the SEC in adopting new laws and regulations for auditors of public companies.

I will give you a specific example of this cascade effect.

After the SEC issued new rules on auditor independence in late 2000, the GAO followed suit with its independent standards earlier this year. Its requirements not only duplicate, but also in some cases exceed, the new SEC restrictions on nonaudit services by broadening the scope of services prohibited and CPA firms affected.

I recently received a letter from a sole practitioner in Denton, Maryland, a small rural community on the Eastern Shore. In his letter——

Chairman SARBANES. Eastern Shore of Maryland, yes.

Mr. BALHOFF. Thank you.

[Laughter.]

Of Maryland. Did I not mention Maryland?

[Laughter.]

Senator GRAMM. It is one of the nicest places on the planet. That's why.

[Laughter.]

Chairman SARBANES. It is a wonderful community.

Mr. BALHOFF. Do I get more time?

[Laughter.]

Senator DODD. What a subtle touch here.

[Laughter.]

Mr. BALHOFF. In his letter, the CPA explains that one of the new GAO restrictions that exceed the SEC's rules requires firms such as his to assign separate personnel to perform nonaudit work. Of course, as a sole practitioner, he has no other personnel to assign. He explains that the practical result will be that he will either have to give up his solo practice and associate with a larger firm, or tell his GAO clients that they will now need to hire a second firm to perform the nonaudit work, an alternative that for many such clients is not economically feasible nor justifiable.

Small businesses have long depended on small accounting firms to provide much more than audit services. The CPA serves as the "trusted advisor" of the small business owner. For example, a CPA firm will often assist a small business in starting out, as well as providing guidance on setting up record-keeping systems, providing tax and estate planning and making suggestions to help make the business more successful. The CPA also helps the business as it grows. Allow me to give you an example.

I have one client, and this is in Louisiana, that had decided to expand its business by adding a new location. After asking questions concerning its projected increase in sales, changes in gross margins, and expected competition, as well as the impact on their financial statements, I helped the client develop a financial model to address these issues. The bottom line was that the company decided that, if it had gone forward with its original plans, it would have risked the very financial stability that it took decades to build. This is just one example that displays the important role CPA's play in providing small businesses with the information necessary for them to maintain their financial strength.

As I am sure you will agree, successful small businesses are the cornerstone of Main Street America. It is likely that, in many cases, if the CPA does not have the ability to act as the "trusted advisor" to his or her clients, many small businesses will simply not seek the input of a third-party professional. It is vital, both for the small business person and for the survival of the thousands of CPA firms, that current laws not be changed in a manner that is insensitive to these concerns.

My second topic addresses how new legislation might affect the ability of our profession to retain personnel and attract new entrants into the profession. This is already an area of great concern for firms of all sizes, and research undertaken by the profession has uncovered alarming trends.

Specifically, studies completed by my committee confirm that we are experiencing significant difficulty attracting students into accounting programs and into the profession.

In a 5 year period from 1995 to 2000, we have experienced a 33 percent decline in the number of students enrolled in accounting programs, as well as candidates sitting for the CPA's exam.

Our surveys show that the major reason fewer qualified candidates are studying accounting is because the profession is perceived as narrow and focused too much on historical "numbers," whereas other business careers seem much more rewarding and exciting. It is critical that we change this perception and continue to attract young, bright minds into the accounting profession. Any

efforts to recruit students to the CPA profession could be severely undercut by any reforms that restrict services audit firms are able to provide for clients.

There is much to do post-Enron to restore confidence in Corporate America and the accounting profession. As you have heard from my colleagues, the AICPA and its members, large and small, fully support many important reforms. But as Senator Gramm said, as Congress considers these issues, we urge you to consider the unintended consequences of short-term legislative solutions in your effort to respond to the Enron business failure.

Thank you.

Chairman SARBANES. Thank you very much, sir.

We will now hear from Olivia Kirtley. Ms. Kirtley was Chair of the AICPA Board of Directors in 1998 to 1999. Actually, I think she was the first woman to Chair that Board. She was Vice President and CFO of Vermont American Corporation from 1991 to 2000. Vermont American is a manufacturer of power tool accessories and was listed on the American Stock Exchange until 1990.

Ms. Kirtley currently serves as a member of the board of directors and chair of the audit committees of two public corporations.

We are very pleased to have you with us this morning.

STATEMENT OF OLIVIA F. KIRTLEY, CPA
FORMER CHAIRMAN
BOARD OF DIRECTORS, AICPA (1998–1999)
RETIRED VICE PRESIDENT AND CFO
VERMONT AMERICAN CORPORATION

Ms. KIRTLEY. Thank you very much, Mr. Chairman.

Actually, I am a board member and chair of the audit committees of three public companies.

Chairman SARBANES. Well, I apologize.

Ms. KIRTLEY. My remarks today will focus primarily on matters of corporate governance, including the roles and responsibilities of audit committees. I want to begin by discussing the importance of advice received from external auditors based on my experience as a former CFO, as well as an audit committee member.

Some of the reforms being proposed would strive to strictly limit the use of this very important resource by companies and by their boards. There are a number of areas outside the scope of financial statement audit in which a company's independent CPA is in the best position to offer advice. This advice benefits the company and its shareholders rather than compromising the integrity of the audit. Not only will costs rise and efficiencies decline, but business decisions will suffer from the loss of expertise provided by the auditor's deep knowledge of the business.

There are SEC rules in place to protect the public by requiring that the outside auditor disclose to the audit committee all relationships with the company that may impact independence and objectivity. After evaluating the report and discussing it with the auditor, the audit committee discloses this information to investors in its proxy statement. This rule has only been in effect a little over a year and we should allow it time to work. We need to be careful not to unnecessarily restrict a company and their board's ability to access the external auditor as a valuable resource.

In the area of audit committee composition, we all know that the work of audit committees has become more difficult and demanding and it is certainly under more public scrutiny. In recent years, audit committees have been the subject of much study and attention. Just 2 years ago, new rules were issued by the SEC and the stock exchanges addressing the independence and the experience of audit committee members.

One of the new rules is that corporate audit committee members must be financially literate, but only one member must have accounting or related financial sophistication or expertise.

Presently, the definition of financial literacy is nebulous at best, with two different market regulators adopting different, yet vague, definitions that may not be sufficient to meet shareholders' increasing expectations.

We recommend that the listing authorities consider requiring all audit committee members to have auditing, accounting or financial experience in order to minimize the reliance on one committee member. If a member lacks sufficient expertise, he or she may not understand the issues, know the questions to ask, or have a basis for considering the adequacy of the responses provided.

Audit committee work, like public accounting work, requires significant judgment. It is not an exact science. Accounting and financial sophistication or expertise will not guarantee that mistakes in judgment will never be made, but it certainly should mitigate the risks.

The final area I would like to discuss is audit committees communications. The Blue Ribbon Committee on the Effectiveness of Audit Committees cited a need for improved and more frequent communication between audit committees and independent auditors that would cover such important areas such as estimates and judgments, internal controls, significant risks, and the clarity of the company's disclosures. In response to these recommendations, new auditing standards and audit committee charters have created a framework for such enhanced communications to occur on a regular basis.

In addition, a quarterly review is required to be performed by the independent auditor, and the auditing standards board recently implemented a requirement that the review results be discussed with the audit committee, or at least with the audit committee chair, prior to the quarterly filing with the SEC.

Chairman Pitt has called for improved interaction between audit committee members and senior management and outside auditors.

A step that would further strengthen open and candid communication would be to require audit committees to hold separate executive sessions on a periodic basis with financial management, with independent auditors, and with internal auditors. The use of executive sessions as a fact-finding tool is indispensable, providing an environment where committee members are able to probe more deeply to assure they are fully informed regarding risks, issues and judgments, and that the participants are given the opportunity to confidentially voice concerns they might not otherwise express.

In closing, it is critical to note that many significant audit committee rules and regulations have taken effect over the last 2 years as a result of the Blue Ribbon Committee. During this period, the

SEC and stock exchanges have implemented many new measures, including the requirement of the formal audit committee charters. These new requirements must be given time to work. In my experience, I have seen significant improvements in the effectiveness and communications of audit committees since the new requirements have been implemented. We must resist the temptation to layer on too many additional rules before giving recent audit committee requirements a chance to work.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much.

Our concluding panelist is James Gerson, Chair of the Auditing Standards Board of the American Institute of Certified Public Accountants, and a partner in the national office of Pricewaterhouse-Coopers, where he is the assurance policy and communications leader. Mr. Gerson has been a member of the Auditing Standards Board since 1992, and he has also been a member of the Peer Review Committee of the Institute's SEC Practice Section.

Mr. Gerson, we would be happy to hear from you.

STATEMENT OF JAMES S. GERSON, CPA
CHAIRMAN, AUDITING STANDARDS BOARD, AICPA
PARTNER, PRICEWATERHOUSECOOPERS, LLP

Mr. GERSON. Thank you, Mr. Chairman.

The Auditing Standards Board is a senior committee of the AICPA authorized to set authoritative auditing standards that are commonly referred to as Generally Accepted Auditing Standards. These standards apply to all audits, both the public and nonpublic entities. The committee has 15 members appointed to achieve an appropriate representation among CPA firms of different sizes, as well as the public. At present, 2 of the 15 seats are reserved for public members, currently filled by an academician and a Government auditor. We hold regular meetings that are open to the public and are attended by representatives from the SEC, the Public Oversight Board, and other constituents.

Let me focus briefly on the role of the independent auditor in the financial reporting process. The management of a company prepares the financial statements in accordance with Generally Accepted Accounting Principles. The objective of an audit is to provide assurance on the credibility of these financial statements. An audit consists of a series of test procedures designed to gather evidence to enable the auditor to express an opinion as to whether financial statements are presented fairly, in all material respects, in accordance with these Generally Accepted Accounting Principles.

The auditor's conclusions are reflected in the auditor's report. The goal of financial statements accompanied by an auditor's report is to provide information that is reliable and useful to investors, creditors, and other constituencies.

I would like to tell you in the remaining time allotted what we are doing to improve the quality of the audit, and let me start with our fraud project.

Let me assure this Committee that, as auditors, we recognize our responsibility to plan and perform every audit to obtain reasonable assurance, within the limitations inherent in the nature of an audit, as to whether the financial statements are free of material

misstatements, whether caused by fraud or unintentional errors. Even a properly designed and executed audit, however, cannot provide a 100 percent guarantee that a material fraud will be detected. Nevertheless, we are working hard to continually improve auditor performance.

In this regard, we issued an Exposure Draft just last month of a proposed revision to our standards on the Consideration of Fraud in a Financial Statement Audit. This proposal, in our opinion, will substantially enhance the ability of auditors to detect material misstatements arising from fraud.

A major change in this new standard is the addition of required procedures that respond to the POB Panel on Audit Effectiveness's call for a forensic-type fieldwork phase by requiring, even when fraud is not suspected, and as part of every audit, including all public companies, the following: Discussions among engagement team members as to how and where fraud could occur, setting aside any prior beliefs they may have had about management's honesty and integrity. Specific inquiries as to fraud prevention programs and controls established by the company. A requirement to perform certain specific audit procedures to test for the intentional override of internal controls by management. And a continual evaluation of fraud risks throughout the audit, as well as a re-review at or near the end of the audit process.

Also, last year, we formed a task force that is working together with international standard setters to improve the auditor's risk assessment process, to better understand where material errors are more likely to occur in the financial statements, and what auditing procedures are best suited to respond to those risks identified.

We also expect to expose for comment this spring a new standard on auditing "fair value" measurements. We have previously issued detailed standards on auditing derivatives and similar financial instruments. Additionally, we are in the process of updating and improving our related audit guide and will be adding a new chapter that will provide guidance on auditing energy and other commodity contracts.

This past December, in response to recent events and in time for this year's audits, we issued an auditor's "tool kit" to serve as a valuable reference guide when dealing with the complex topic of the potential abuse of related-party transactions.

In addition, in response to growing demand for more frequent and timely reporting, we are actively involved in developing continuous auditing methodologies. Actual implementation will evolve, as the concept of more frequent reporting gains additional support and as appropriate, specialized software tools emerge.

Investors depend on auditors to communicate the reasonableness of the company's financial information and to provide confidence in the numbers. When an investor reviews a company's financial statements, an independent audit should provide the investor with confidence that the company is playing by the rules.

As a profession, we are committed to continually improving our auditing standards and the guidance we provide to auditors, so that investors and others who rely on an auditor's report can place full confidence in the audit process and the members of the profession who perform this valuable service.

Thank you.

Chairman SARBANES. Thank you very much, sir.

We thank all of the panelists.

We will now go to our rounds of questioning.

Let me say at the outset that I think we are very obviously mindful of the argument about unintended consequences. But we cannot for a moment permit the unintended consequences argument to swallow up the necessity, at least as I perceive it, of making systemic and structural changes. And with all due deference to the panel, I do not think there is a full appreciation of just how critical I think this situation is at the moment.

I am not going to go through everything, chapter and verse, but even *The Wall Street Journal* yesterday in an editorial supporting Volcker's suggestions for Andersen, which they then thought would become a model for other accounting firms, the editorial says: "As long as we have audits, investors should have confidence that the auditing signature means something. It is clear enough that as accounting firms have transformed themselves into full-service consultancies, the consultants have often wagged the auditors." And then they go on to describe that process.

In the *Journal* this morning, their lead story is "Did You Hear the One About the Accountant? It is Not Very Funny." And that is President Bush's joke. I won't put the joke out here. "How A Decade of Greed Undid the Proud Respectability of a Very Old Profession." Then, of course, *The New York Times* also has a long story on Andersen: "A Once Proud Company is Humiliated by the Enron Debacle." And they have some interesting quotes from Judy Spacek, who is the daughter of the other pioneering executive besides Andersen in establishing that old line firm.

So, I think there are some real challenges here. And I do not think they are going to be corrected by half-way measures.

Our search is to find out the measures and to make sure that they are sensible and that they will work. But it is my own perception that we need some substantial changes in the way the system and structure works if we are going to guard against this.

Now having said that by way of opening, there are a couple of questions I want to ask before my time expires here.

I want to address this issue of cascade, which the institute has already sent an alert out to its members, sounding the warning bells and the dangers and that small business will be done under and so forth and so on. Do you perceive that once you represent a listed company, that there are important additional obligations which go with playing that role?

Mr. Balhoff, you said that you had only three clients that were listed companies.

Mr. BALHOFF. Right.

Chairman SARBANES. Now it may be that if you are going to play in the listed-company arena, you are going to have to recognize that there are going to be tougher demands on you than if you stay out of that arena. Our focus has been essentially in the listed-company arena because that is where we have most sharply put the investor protection issue and the confidence in the markets.

Your argument is apparently that whatever has happened in the listed-company arena is going to cascade into the other arena and

therefore, we are going to be impacted by that. But by the same logic, I do not know that I can accept a cascading up concept, which says, because of our problem in the nonlisted arena, you cannot do this, this, and this with respect to listed companies. Do you see a greater responsibility when you are dealing with a listed company?

Mr. BALHOFF. That question is for me?

Chairman SARBANES. Well, anyone on the panel.

Mr. BALHOFF. I will take that, initially at least. I believe that the responsibility, when you audit a company, is to see that the financial statements are fairly presented. And there, to whomever the readers in a listed company, obviously, you have more shareholders and more readers of the financial statements generally than in small businesses, most of the companies that we represent.

I think that you have to be conscious of that when you are auditing. And addressing the issues of consulting services, my belief is consulting services are getting bad names right now. We are putting everything into the bucket of consulting services and I think we need to understand the types of consulting that happens with engagements.

I can tell you, even for our public companies that we audit, which actually are SB's, they function in terms of their size and their needs are a lot like private companies. But to the extent that consulting services provide information to management, I think we are working in the public interest. We are helping those companies, whether they are listed or nonlisted companies, to better run their companies. I think that is a public interest.

To the extent that any of our consulting services may put us in the position of management, then I absolutely believe there is a conflict and I believe that is for listed or nonlisted companies.

Chairman SARBANES. Does anyone else want to add to that?

Mr. CASTELLANO. I might add something to that, Mr. Chairman.

I do think we should recognize that whatever is done here in terms of legislation Federally, is looked at by State boards of accountancy in setting independence rules in the States.

Chairman SARBANES. Well, they may have to sharpen up their ability to make the differentiation.

Is it correct that about 95 percent of the listed companies are represented by the five major accounting firms?

Mr. CASTELLANO. I believe something in excess of 90 percent is the right answer, yes.

But what we may want to look at is this new public regulatory body that we fully support, as I said, may eliminate the need for bright-line, prescriptive rules in matters such as what specific services should or should not auditors be allowed to provide for their audit clients.

Because this new board will be, in fact, inside these firms that do these audits on a regular basis, a continuous basis, evaluating audit quality and making assessments as to whether firms are in fact independent rather than whether there is merely a perception of an independence impairment. So, I think the new regulatory board that we are fully in support of may compensate for the need to have bright-line prescriptions on certain services.

Chairman SARBANES. My time is expired. I will come back.

Senator Gramm.

Senator GRAMM. Mr. Chairman, thank you very much. I want to thank each of you for very good testimony.

I do think it is very important as we go through this process, despite all the public pressure that is going to be brought to bear in the debate, that people who understand your profession stand up and speak out on these issues.

I am not taking exception to what the Chairman said, but I am taking exception to *The Wall Street Journal.* If this last decade was a decade of greed, may God give us many such decades, because the poverty rate among children fell by 20 percent in the last decade. I think there are many people who are trying to take this Enron thing and use it to discredit capitalism itself. I just do not think the case can be made.

I think a case can be made that we need to look at what happened as best we can determine. And I think the nature of the world we live in is that we are going to be forced to make a judgment before anybody really knows what happened at Enron. But we need to determine what happened and we need to find ways of trying to deal with it, both to make things better and to improve the system, and also to bolster public confidence. I think that is our challenge.

I would like to raise a couple of issues. First of all, I think everybody agrees that part of the reform is greater independence for this oversight board and a secure financial base. This raises another question which may not concern many people, but it concerns me, and that is the whole accountability of the people who end up in these positions. A, are you concerned about that? And B, how would you deal with it?

You do not have to ask anybody for money. You are giving people ability to subpoena. You are giving people power to set accounting standards. How would you deal with the whole question of checks and balances and accountability? Rapid turnover of the people?

Let me just start with that. And if you all can be brief, this 5 minutes goes fast when you care about the subject.

Mr. CASTELLANO. I will start, Senator Gramm.

We believe that there should be very careful consideration as to how members of the public body would be nominated and in terms of their terms and the background of the people that would serve on such an important body. I think there should be some checks and balances in terms of that body being subject to SEC oversight, as I said in my testimony.

Mr. COPELAND. Senator, I think you have asked a very important question. I have no problem with the concept of a board that basically would represent independent rather than self-regulatory processes, so long as there was some accountability for the people on those boards. Now how to provide that and still leave them largely independent is a real challenge.

But I would just say that it is absolutely essential that whatever body is involved in our oversight in whatever way, has the absolute trust and confidence of the public, of the Congress, of the Commission, and of the people that they are overseeing.

Somehow, coming to a point where we bring all of that together, I think any process that would assure that, I would vote for.

Ms. KIRTLEY. I hope we would look to some of the improvements made in the corporate governance structure and apply some of those very same safeguards and checks and balances to a body such as this. I think it is very important, and Mr. Castellano's point about the nominating process is extremely important. And I hope that we would look to some of the things that we currently have in place and have put in place for corporate governance in that regard.

Mr. GERSON. I think the issue of accountability and funding is an interesting one. I am not sure that anybody, including the Federal Government, operates in an environment of total discretion on spending, whatever it is, that you think you need to spend.

Senator GRAMM. Well, our whole system is based on preventing that from being the case.

Mr. GERSON. Yes, right.

[Laughter.]

Senator GRAMM. One final question in the time I have left.

There is a real question about who ought to be on this board. I guess my own views are that if you are going to have an ethics subpanel, that perhaps there is some logic to having maybe even a majority of people who are non-CPA's.

When we are setting accounting standards, I have to admit that it frightens me to have nonaccountants in the majority in setting such standards. And when we are setting those standards, maybe we ought to require a super-majority of the panel, no matter how it is made up. Does anybody have any thoughts on that they want to throw out?

Mr. CASTELLANO. Let me say first, Senator, that the public regulatory body that we support would take from public oversight to public participation two key aspects of what have been historically part of the self-regulatory regime of the accounting profession. This is unprecedented reform. That is discipline and peer review.

We are not advocating that accounting standards, which are now set by the Financial Accounting Standards Board, be set by this new public regulatory body. We fully support the FASB as a private-sector standard setter for accounting standards.

The auditing standards board has historically done an outstanding job of establishing auditing standards for our profession. I think there is no doubt that our auditing standards are the finest in the world and have contributed to our capital markets being the envy of the world.

The public body that we recommend and fully support would again be unprecedented in taking over the discipline and peer review for public company auditors.

So, to that extent, the composition of the board—I do not have strong feelings about it. I think people with financial acumen, some people from the profession. But we certainly support a publicly dominated board, would be appropriate.

Chairman SARBANES. Could you answer the super-majority question? That was imposed upon FASB and some people feel that is one of the reasons that FASB has had difficulty putting forward regulations. They used to operate just on a straight majority. Then a super-majority requirement was imposed upon them. I might also note that the Supreme Court decides very momentous issues affect-

ing the whole structure of our constitutional system without a super-majority. Do you have a view on the super-majority issue?

Mr. CASTELLANO. It is hard to answer that one question in terms of how this would be structured, Mr. Chairman, unless we know the composition of the board. And that is, the background from which the members would come. Are they all public members? Are they a combination of public members and people who have previously been in the profession? Some people who are currently in the profession? I think it would be premature for me to express an opinion until we know the composition.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Let me just say that I think that one of the problems we have in this whole discussion is it is so Enron-focused, it gets off of the pertinent issue that we had 158 restatements last year, which gives, I think, investors and people who analyze statements real pause for cause. Three times the numbers in the 1990's. I think the paper said today there were three restatements in 1981. Something's going on that causes people to have major changes in how the earnings of companies have been reported and what actually happens.

So, I hope that it is not just an Enron-derived issue that I think we are trying to talk about here. Sometimes I feel like we get so focused on that, that it is mistaken.

I am pleased that you all are for this independent regulatory oversight crowd, group. But I am troubled when I hear the term, peer review. The reason I am troubled is, if I am not mistaken—and I ask whether this is, in fact, the case—but has the peer-review process ever resulted in any kind of disciplinary or dissenting view with regard to another one of the peer's auditing practices?

Why wouldn't we want the oversight board to have the ability, as the SEC does, as the New York Stock Exchange does, as maybe Nasdaq does with security firms, or the Federal Reserve with regard to banks and other regulatory bodies, to actually go in and audit the auditors themselves?

I think that is one of the major issues that I hope that we would be able to come through this process. I think that is the theme of one of the elements of the bill that Senator Dodd and I have suggested. I would love to hear your comments on it, but I would go back to the peer-review process. It certainly hasn't challenged these restatements. And it certainly hasn't led to a lot of dissent and challenge of breakdowns that might have occurred in different situations in a period of time, other than Enron.

Mr. COPELAND. Senator, maybe I could respond to that. First of all, I do think there are improvements that could be made in the peer-review process. Those were recommended in the Panel on Audit Effectiveness' Report. And my understanding is that those changes are being worked through the process.

Senator CORZINE. Is it true, by the way, that there have been no sanctions brought against a firm or dissent?

Mr. COPELAND. Yes. But it is not true, though, that there have been no comments and recommendations coming from those publicly issued comments and recommendations. Those are made in virtually every peer review. It is a little bit like an audit report.

It is either adverse or unqualified. It basically would be a death sentence for a Big 5 firm to have an adverse opinion coming out of a peer review.

Also, you should understand that because of the processes in place under the AICPA for the investigation of challenged audits, whether in the claims process or whatever, those audits and those engagements are reviewed through the QCIC process rather than through the peer-review process. For example, in the peer review of Andersen, the Enron engagement was excluded from that peer review and would be reviewed in the QCIC process.

So there are two separate processes, one for troubled engagements and one for the practice at large.

Senator CORZINE. Okay. Could you comment further on whether peer review is what you think the independent regulatory body should do, or whether you could conceive and would be embracing of the kind of New York Stock Exchange, NASD, or SEC audit by the independent body?

Mr. COPELAND. I do think that there are—and for many reasons right now, I particularly would support the change from a peer-on-peer review process. I do believe that some significant changes in that process could enhance the public's confidence, whether it is the process you described—I am not familiar with that—but there are some excellent recommendations again from the Panel on Audit Effectiveness.

Let me just add one other thing, though, that people have suggested because there have been no adverse opinions, that we should do away with the peer-review process.

I think that would be a serious mistake. I can only assure you that when our firm is going through a peer review, we sweat bullets and we do pay attention to what we do, and the knowledge that another firm will be looking over our shoulder.

I think that would be a little like saying that because traffic laws aren't successful in eliminating the 25,000 fatalities we have every year, that we should do away with traffic laws.

The peer-review process helps. If we can figure out ways to improve it, we absolutely should do that. But to throw that out I think would be a step backward. I think the peer-review process, as it was developed 15 years ago, was an excellent idea.

Mr. BALHOFF. If I could make a quick point. I think there have been adverse reports in peer review and there have been modified reports in peer review and there are follow-up actions that require education and sometimes oversight, preissuance reviews. So peer review, the process itself has resulted in a number of different monitoring actions on firms across the country. I know because I have seen some.

Although some of the largest firms may not have had adverse or modified, I can assure you that the peer-review process has resulted in that, and in fact, I think that Mr. Copeland's correct. I think it has been a very positive process for the profession.

Mr. COPELAND. I stand corrected. I have, I admit, a Big 5 focus.

[Laughter.]

Senator CORZINE. Thank you.

Chairman SARBANES. Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman. This has been another very exciting day.

[Laughter.]

I just love it when we have accountants in here.

[Laughter.]

I would like to point out that this is the first panel that I can remember that stayed within their time limits.

[Laughter.]

Which shows what rule-followers accountants are.

[Laughter.]

I do hope that my colleagues will take a look at the testimony that was provided. It does address more specific questions that we have been having about the accounting profession than any of the voluminous texts that we have had in the past.

I think they give us some answers that will help cover this range from small accountants to big accountants.

There is quite a bit of variety in what was presented this morning. I appreciate Mr. Castellano and Ms. Kirtley talking about audit committee requirements and particularly Ms. Kirtley's comments about financial literacy, which she did not have time to go into a great deal in her testimony.

If we have people on audit committees that had more financial literacy, and that fits in with the hearing that we had on financial literacy, I think the companies would be a lot better off and the investors will be a lot better off.

Mr. Copeland, I really appreciate the information that you have on auditor rotation and the information on the separation of consultants from the auditing process. And I will get into that a little bit more here in a moment.

But for Wyoming, Mr. Balhoff is the prime example because all we have are small accounting firms in Wyoming. And of course, they are auditing small firms. Those firms do expect that when they have that exit interview, that they not only find out the things they have been doing wrong, but also they can find out the things that they have been doing better.

I know how disappointed they are going to be when it gets to that point and because of cascading, the auditor tells them, oh, I am sorry, that is consulting. You are going to have to pay another firm to come in and look at exactly the same information, do exactly the same work that we did, and pay them as much or more in order to get that other question answered.

Every time I have seen something that affects the companies that audit the SEC filings, it does wind up coming down to the States and the States having less hearings and less information, but imposing the same rules on those small companies.

We have to be very careful that what we do here does not wind up doing that same thing.

Mr. Gerson, what I really like in your testimony is that you tell people what auditing is.

[Laughter.]

That is a very important piece that is missing from this whole process. We are assuming that everybody knows what auditing is. I have found that there is quite a bit of variety in what people are picturing as auditing and they are thinking more of the times that

they have sat down with their IRS agent and answered questions, often for which they have been kind of bombarded and surprised.

They do not recognize the continuity that is necessary in this, or the realm of information that is necessary in it because it is not supposed to be a gotcha situation. It is supposed to be assurance that the best accounting transparency is provided.

And there are some different techniques that are involved in that, than what is involved with the IRS. But I guess I better get to the questions. I am running out of time and I am one of those rule-followers, too.

[Laughter.]

I would ask Mr. Copeland to comment—well, no, I am going to make some more comments.

[Laughter.]

We talked about forcing this rotation of auditors. I have to say that it was Congress that caused the problem to begin with. We have written all of our documents and questions and things to keep companies from shopping for auditors, to make sure that they are allowing full enough time for people to understand the business completely and to be sure that they are not applying pressure to the auditors with this threat of firing them.

So everything that we have done has been toward saying, if you get rid of an auditor, take a look because there is something bad happening there. And now we are about to do a reaction, perhaps an overreaction, and say, unless you are changing auditors, you are doing something bad.

We are going to have to reach some middle ground here, I suspect, where we recognize the errors that we are making and have made in the past and also rely on that financial literacy of an independent audit committee to be able to make the kinds of selections on when it is time to change auditors.

I do have some questions which I will submit to you since I got carried away here.

Chairman SARBANES. Thank you very much, Senator Enzi.

Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Thank you all for your testimony. It is very, very helpful. I want to make a couple of quick observations if I can.

First of all, I want to underscore the point that Senator Sarbanes made. We have all acknowledged the unintended consequences and we are all very much aware of that. But I would also be very quick to add that there are more than just unintended consequences if we do not act.

We are in a relatively brief session here with an election year coming upon us. We have a lot of work to do on appropriations bills and other things. These hearings have been very, very important, and while we are not going to act precipitously, it is going to be critically important that we act. So, I wanted to make that point to all of you.

Chairman SARBANES. Let me say, that is certainly the Chair's intention. We are trying to be thorough and careful. But it seems to me it is clear that changes are needed and we intend to do all we can to see that that happens.

Senator DODD. I appreciate the Chairman making that point again.

And to my friend from Wyoming, I know that he is drafting legislation as well and will be submitting a bill on this matter. I am sure that there are no unintended consequences of what he is drafting here.

[Laughter.]

We are anxious to see what he proposes. Let me just make the point here, and I am preaching to the choir when I say this. I certainly know Mr. Copeland. I don't know the rest of you that well. But I have a lot of confidence in the integrity. I think the comment of Colonel Carter that the Chairman talked about and who audits the auditor, and he says, our conscience.

I do not think he said that lightly or frivolously and I think over the years, there has been that strong sense. This is the difference, I suppose, when you understand the unique problems in smaller companies and so forth, not public companies that the Senator from Wyoming has pointed out. But there is a different set of circumstances in accounting and auditing.

A consultant has one client. It is the client that has hired them. They do not have a responsibility beyond the client that has asked them to do the consulting.

A lawyer has one client. He is an officer of the court. It is a bit beyond that. But, nonetheless, their primary responsibility—in fact, ethics say that their obligation is to the client.

The auditor has a broader responsibility. It is not just the client that has hired you. There is a fiduciary responsibility that transcends just the person who pays the bills. It is that person out there is who's making investments and trying to decide how to make solid and intelligent decisions.

Historically, we have relied on you, or at least the investor community has relied on you. We have no one else to really rely on in making these things. So the notion somehow that this is just an auditing function and a consulting function and a lawyer's function are all the same—I see you are agreeing. You are nodding your heads. It is different. Can you all agree with that? Am I overstating the case? It is very different. Is that not true? I am listening.

Mr. COPELAND. Yes, I agree.

Senator DODD. I just want to make that point. I think that is a very important point here.

Also, I want to underscore the point that Senator Corzine made. This is not just about Enron, any more than the election of 2000 was about Florida. What Florida pointed up is a serious problem with election laws around the country, and Florida highlighted it for all of us. Enron has highlighted a set of issues that we need to address. But if we suggested that all we were doing is crafting legislation to respond to Enron, that would be foolish, in my view, at this juncture. We do not know a lot yet about that. There are a lot of things to be done. It has highlighted problems. But to suggest that it is just an Enron bill I think would be a mistake.

Let me, if I can, get into this.

First of all, I always believe in starting with where we can agree a little bit. I agree with the issue on the rotation question.

I think in our bill, we ask for a study to look at this. You did not include in your testimony, but I have always thought a very worthwhile argument is that different accounting firms have different specialties, even among the Big 5.

The idea that there is a cookie-cutter approach here that one accounting firm can do the job of any other accounting firm because you are mirror images of each other, is just fundamentally wrong. There are specialties and so forth.

The idea of rotating accounting firms, in addition to the arguments you have made, Mr. Copeland, in your testimony, it may be more forcefully made by the idea that it is really an impractical suggestion as to how to deal with it. So, I agree with that.

None of you commented on the issue of FASB's independence, about who pays FASB. Senator Corzine, Senator Stabenow, Senator Johnson, and I have suggested that we ought to come up with a different financing scheme for how FASB is financed. Other than maybe adopting a particular suggestion, do you agree that the suggestions we have made in our proposal make sense, I presume you would agree. I presume it is one less cost you have.

[Laughter.]

Mr. COPELAND. Senator, from my perspective, I think if you can make them independent financially, that is great, as long as you have perhaps some kind of periodic sunset provision or something that allows Congress to look at the utility of the institution itself periodically to be sure it has a continuing utility. For example, if you decided you wanted to go to international accounting standards on a global basis, you would need some way to unwind that.

But I certainly do not disagree, without knowing the details of your proposal, that an independent financing for FASB would be a great idea. It would make them even more independent.

Senator DODD. Do you all agree with that?

Mr. GERSON. It might be worthwhile to note that the Financial Accounting Standards Board is not a part of the AICPA.

Senator DODD. I know that.

Mr. GERSON. It is a separate organization.

Senator DODD. But because none of you really commented on it too specifically, in your testimony, I accepted the notion that maybe you agreed with what Senator Corzine and I have suggested here, without necessarily getting into the details of it, of that particular organization.

Now let me come back to scope because that is a big issue and the independent auditor.

I want to draw you out on this a bit. Before I do that, I have to ask you this one question. Obviously, I think there is a real possibility of Arthur Andersen going bankrupt. That is a suggestion I make. I am not suggesting you are endorsing that. But I wonder if you might just comment briefly on the implications of that to the markets. With some 2,200, I am told, clients, what would be the implications to the industry and to any market implications that that would be the case?

Mr. COPELAND. Senator, I would be happy to respond to that. I have been on record since the last spate of proposed mergers saying that I thought the further consolidation of our industry would not be in the public's interest. I continue to believe that. I actually

think we went a bridge too far. So, obviously, I agree that losing Andersen or losing one of the Big 5 firms, depersonalize it from Andersen, would not be good for the capital markets. It would limit the number of choices. It would limit the amount of competition.

However, if it is going to happen, by necessity, then I think it is important that that process be managed in a rational and comprehensive kind of way to avoid any sense of concern on the part of the public markets.

We would certainly, as a firm, and I am sure our colleagues in the other firms would agree in the AICPA, that we would cooperate fully with the Securities and Exchange Commission in being sure that that consolidation was orderly, so that there was no chaotic result in the capital markets.

Senator DODD. Would you like to comment on that?

Mr. CASTELLANO. Senator, I would like to just follow up on Mr. Copeland's comments.

I would reemphasize that we will be committed to work with the SEC to ensure the stability in the capital markets and whatever happens there.

I would say that there are about 800 firms now that do audit public companies, all members of the SEC's Practice Section of the AICPA. So some of that capacity, depending on size and scope of the entities that need to be audited, can be absorbed by these other firms. It will be a challenge.

I think it emphasizes the importance for all of us to be cautious in what we do because we do need a vibrant and viable accounting profession to serve these companies and the shareholders.

Senator DODD. Thank you, Mr. Chairman. I will come back to the scope questions in the second round.

Chairman SARBANES. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman. And thank you all for your comments.

I would like to go in a little different direction because it is clear from the reports on Enron that there were people in the company that knew there were problems, and that there were questionable procedures and standards, ethical business practices were undermined. My concern is whether or not there was a corporate culture that discouraged people to come forward or discouraged dissent.

It appears there were well-meaning people that knew there were problems and if they had been able to raise a red flag earlier, they may have actually stopped a situation that has hurt thousands of people in an extremely serious way.

So, I would like to ask you about the issue of whistle-blowing. I am wondering if auditors should have a confidential mechanism to allow employees at companies that they audit to draw attention to potential fraud or earnings manipulation. Should there be a way that employees could confidentially express their concerns to the SEC? How would you suggest having a mechanism to be able to allow information to be shared?

Mr. GERSON. We considered this very significantly when we were doing our new proposed standard for auditing for fraud.

The concept of having a separate hotline to the auditors is very difficult to manage. We have upward of, if you include all our clients, public and nonpublic, maybe 10,000 clients in a firm the size

of PricewaterhouseCoopers. And to try to manage a hotline with that degree of volume would be very difficult.

We have introduced some requirements in this new standard in response to some of these problems. Specifically, we have added a requirement that auditors get representations from management as to whether they are aware of any allegations of this type of activity because there have been, frankly, some situations where company management knew about it and did not tell the auditor. And we would like to know.

So rather than setting up our own hotline, we are expanding the requirements on the auditor to find out what is going on inside the company, and also encouraging auditors to speak to people outside the financial organization because the more people you talk to and the more questions you ask, the more likely it is that you will come across some information that will start you down the trail.

Chairman SARBANES. What is the magnitude of that burden if the hotline applied only to public companies, not the nonpublic companies?

Mr. GERSON. I think it is still significant. Companies have hotlines, and I think our experience—we have a hotline of our own, within our firm. And our experience has been that upward of 95 percent or more of the things that come in on the hotline are not related to fraud or fraudulent reporting.

Most of the things, frankly, that come in on hotlines are human resource issues—complaints about working conditions, complaints about my boss, things of that nature. And to have all that kind of information filter through the accounting firm, I think, would be very difficult for us to manage. It is sometimes hard to separate those issues. But I do think that we should be paying more attention to those types of activities that are going on in companies and companies should have those kinds of processes in place.

Senator STABENOW. Of course, the challenge is that it appears that there were managers that knew what was happening at Enron and did not share that information.

Does anyone else want to comment?

Ms. KIRTLEY. Senator, if I may. I think from a corporate governance perspective, if audit committees were required to hold private executive sessions and employees knew that they were required to hold those private executive sessions with financial management, with independent auditors, and with internal auditors, I think that could potentially provide some mechanism where they would know that their message could reach in confidentiality a body who would investigate.

And when you have outside directors, independent directors who are now required to be on the audit committees, I think that there may be a mechanism within that structure to facilitate something that would go a long way in that regard.

Senator STABENOW. Anyone else?

Mr. CASTELLANO. Senator.

Senator STABENOW. Yes.

Mr. CASTELLANO. Thank you.

I will say that we do support corporations having their own codes of ethics. I think your point is excellent.

What this boils down to is corporations having the right culture, having processes within their organizations to evaluate the risks of fraud, and having processes within the company to provide oversight. Perhaps the company should have such a hotline. But at least they need to have the right tone at the top, the right culture, systems to evaluate the rest of these things happening and the right oversight.

We do support, to make this new fraud standard that we are proposing effective, as I said, that it will be a felony for anyone in a company involved in the financial reporting process, to lie to the auditor, or to withhold material information.

Senator STABENOW. Thank you. One other question, if I might.

In previous testimony, we heard about the incredible growth in financial restatements by companies over the last few years. One witness stated that there were 464 revised statements between 1998 and the year 2000, nearly twice as many restatements as in the last 20 years.

I know that several Members of the Committee have expressed concern about this and I know that Senator Corzine mentioned it this morning. But I am wondering if you have a theory on why we have seen this spike in earnings restatements. What would you recommend be done to stop this alarming trend in inaccurate information being given to the investing public, only to be revised at a later date? Should we consider charging companies a significant penalty when they misstate their earnings and have to restate it?

Mr. CASTELLANO. I have a comment for you about that, Senator.

I think we have to look at the cause of the restatements. I think what you will find when we go back and look at what has happened since 1998, is that there have been some accounting series releases that have been published by the SEC dealing with specific accounting issues that have caused companies to have to go back and rethink the way certain transactions have been accounted for, things such as series releases on revenue recognition, materiality, accounting for in-process research and development.

I believe when those releases came out, it caused registrants to have to go back and reconsider accounting treatments. I am sure that has not accounted for all the restatements, but that is an explanation for some of them.

Senator STABENOW. Would you expect that there would be a dramatic decrease, then, in restatements? No? Yes?

Mr. Copeland.

Mr. COPELAND. Maybe I could just speak to that.

The Financial Executives Institute did an excellent analysis on this and I really urge your Committee to look at that analysis.

Basically, the last 3 years, not including this just past year, are compared with the decade previous. When you adjust for market capital gains and losses—in other words, do not look at the number of restatements, but, rather, the market impact of the restatements, it basically boils down to 10 restatements a year each year.

In other words, if you took those 10 restatements out of each year, you would take out the majority of the impact on the capital markets of those restatements and it would look like the years prior. So that may be useful both to auditing firms and to policymakers in terms of where the concentration of effort should be.

In terms of the number of restatements, that can be accounted for in two or three ways, I think. First is, of course, the enormous exponential growth in the body of knowledge within the profession. FASB 133 had over 800 pages, for example.

The second thing is a single issue related to the dot com revolution, which was in process R&D. And that issue simply got ahead of the profession and I think got ahead of the Commission as well, and we had to react to that and that involved some restatements.

The third thing was that one of the accounting series releases basically lowered the materiality factor that is used by auditors and by the Commission to determine whether or not a company needs to restate its financial statement.

So, you are really looking at a population that was created by a different measurement when you look at the last 3 years and compare it to the prior decade.

Senator STABENOW. Thank you, Mr. Chairman.

Chairman SARBANES. Good.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thank you, Mr. Chairman. And to each of our witnesses, welcome. Thanks for taking time out of your lives to be here with us and to help us as we address these issues.

Senator Dodd, I believe, earlier spoke of our election reform efforts and alluded to Florida. I just want to build on that in framing my question.

It goes back to what Senator Stabenow stated in restating of earnings. A big part of what we are interested in doing here is making sure that when individuals or when pension funds or other entities invest their monies, that they know what they are investing in and that what they get is what they think they are getting.

That is a primary concern of ours and focus of ours, and you are helping us to get there.

If we had elections for the Senate, for the House, for governorships or mayoral positions, and we were not infrequently restating the results, so that someone we thought won, but later on we found out that they did not, in fairly short order, people would start to lose even more confidence in our electoral system and their ability to exercise their rights in a democracy.

We want to make sure that we do not have those problems with respect to our democratic system and we want to make sure that the problems that are brought to our attention because of Enron and the restating of earnings, that we address that right away.

I think there are three corrective courses that we can take. One of those is a legislative course, for us to take actions in certain areas. Another is to look to the regulators to take certain actions. And the third is for the industry itself to take corrective actions, in some cases, compelled or encouraged by the market and driven by market forces.

I have been to two other hearings today, so, I have missed your testimony. First, I am going to ask each of you just to give me the benefit of where you agree—forget about where you disagree—but where do the five of you agree on what we ought to do legislatively, particularly with respect to the work that is done in your industry.

Where do you agree, what should we do legislatively? Second, what falls within the purview of the regulators? What should they do? Where do you agree on what the regulators do? Last, where do you agree on what the industry should do?

Mr. COPELAND. Maybe I could just start with that.

I have heard several times mentioned restatements in the context that means the accounting firms made an error. Just for the record, in a great many of those cases, the restatement was caused by the auditor identifying the problem and causing the statements to be restated.

Senator CARPER. I accept that.

Mr. COPELAND. In terms of where we could absolutely reach agreement, I believe that the issue of a more transparent governance process for our profession, oversight process for our profession, and disciplinary process for our profession, would be the most important thing that we could do from the standpoint of restoring the confidence of the investing public.

I believe working together with the Commission, with the AICPA, with Congress, we can come up with an appropriate approach that would allow the investing public to understand that our profession is being properly overseen and, again, hopefully restore the confidence that we have enjoyed over the last many years.

Senator CARPER. Let me just make sure my question is clear. What I am asking is, as I sit here, there are three places that the corrective action can come from, at least three. One is from you, from the industry itself. Two, are the regulators. And three are those of us who are elected. I think you are suggesting that we essentially work together to come up with a corrective joint fix.

Mr. COPELAND. That is my suggestion, yes.

Senator CARPER. I am just asking the others on the panel, what out of those coordinated actions should come from the Congress?

Mr. CASTELLANO. I would like to comment on that, Senator.

I agree, and I said this in my testimony, that we are committed to work with this Committee, the Congress, the SEC, and the FASB and all participants in the financial reporting process, to implement meaningful reforms.

As to what role the Congress should play or what should be done through regulation or what should be done by the profession, I would just suggest that we carefully consider that whatever way the reform is enacted, be done in such a way that it can be responsive to evolving and changing market conditions because one of the challenges of a legislative solution is can that effectively change quick enough as market conditions evolve, or is a regulatory solution a better way with Congress working with the profession, working with the regulatory authorities, to come up with a solution that can be very responsive to evolving market changes?

Senator CARPER. Others, please?

Ms. KIRTLEY. I have nothing to add.

Mr. GERSON. No.

Senator CARPER. I don't think I framed that question very well. We are going to move on. But, Mr. Chairman, I am disappointed with what I just heard and I accept the responsibility. Obviously, I did not frame the question well. I will say it again, and I do not expect you to respond.

There are some things that we need to do. I think they are probably rather limited, we, the Congress. There are a lot of things that you all need to do, and your industry, and there are probably a whole lot more, considerable, than what is appropriate for legislative action. There are clearly things that our regulators need to do. We can help them in that or we can discourage them, as we will. What I was looking for from each of you is where do you agree on what is the appropriate role for the Congress? Where do you agree on what is the appropriate thing for the regulators to do? Where do you agree on what is the appropriate thing for you within your industries to do?

That was my question, and I did not ask it very well because I sure did not get the response that I was looking for.

Thank you.

Mr. GERSON. Is it possible to continue on this?

Chairman SARBANES. Pardon?

Mr. GERSON. Is it possible to continue on this, on the question?

Chairman SARBANES. Why don't you take a moment or two. We have another panel that has been waiting.

Mr. GERSON. Okay. I will be very brief.

I think one of the things that we have laid out is a vision of where we need to end up. It is not always clear to some of us, at least some of us who aren't actively involved in the political process, which parts of it need to be constructed by whom. That is why I think it takes a collaborative effort.

Let us use, for example, this new Public Oversight Board—or whatever its name is—some of its privileges and responsibilities may only be able to be established through legislation. There are some that the SEC could do through regulation and there are things that the profession can do to move it ahead.

Personally, I am not sure how I know to pick which pieces of that each group needs to bring to the table. So, therefore, I do think it is important that we work together.

I think there are some things that the profession itself clearly needs to take the lead on. Establishing a more effective business reporting framework is something that clearly I do not think would be done through legislation. The SEC would have a role in it, but it is something that is very important for us to take the lead on to make sure that the reporting that is done is effective.

Improving the performance of auditors on the individual engagement level in terms of the standards that we put forward for our members to follow is something that we need to take the lead on.

So there are things that each of the groups brings to the table. I think industry has a responsibility also with respect to their role in proper financial reporting.

But most things require bits and pieces to be put together from the different groups and it is hard to establish that unless you have a very clear perspective on what is the goal and then how do you together make it happen.

Senator CARPER. Those comments are helpful. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. I would like to move to the next panel.

Senator Gramm has a question.

Senator GRAMM. Yes, I want to raise an issue here and I will do it very quickly. I want to read you a quote:

> I have served on too many audit committees to know that even though I would consider myself independent, I would consider myself knowledgeable, I did not know what questions to ask the chief financial officer during meetings to find out what it is that conceivably is going wrong with the corporation and he wasn't about to tell me.

Now, you might think this is some guy on the Enron board or this is some guy on Global Crossing, or this is some incompetent. This is the most respected financial person on the planet—Alan Greenspan.

In listening to you, Ms. Kirtley, it seemed to me that you are acting as if somebody—and I raise this question because a year from now, I might very well be on an audit committee, since I am not going to be on this Committee.

Ms. KIRTLEY. You are a brave person.

[Laughter.]

Senator GRAMM. But I want to tell you, I am a lot less likely to do it today than I was a year ago.

Ms. KIRTLEY. Right.

Senator GRAMM. If Coca-Cola asked me to be on their board and their audit committee and I cannot rely on the accountant, and we are meeting four times a year for a day and a half, and people are expecting me to go out and count Coke bottles, I am sure as hell not going to do it.

I think we have to be very careful here or we are going to create a situation where people, competent people, are not going to be willing to serve on these boards.

Somehow, if you do not accept the premise that people have a right to count on the outside auditor, that it is their job to go behind that auditor, then I think you basically write off people that are concerned about their assets from ever being on any aid committee or ever being outside members of a board.

I would like to get your response to that.

Ms. KIRTLEY. If I may comment. You are absolutely right on. The audit committee is not the auditor's auditor. The audit committee should be an oversight body. The audit committee should create an environment for open and candid and free communication, and they should do that by talking to various people throughout the organization that should know.

You are absolutely right. If someone wants to hide something from you, or if you do not think to ask the right question and they are not forthcoming with the information, you do increase your chance of being able to see if there are concerns and risks or transactions that have nuances to it that you haven't been informed of, by discussing privately with these different groups. But there is no guarantee and you do have to trust someone.

I think your point of regarding people willing to serve on audit committees is a very valid point. I know that the recruiting firms for boards of directors have said that they have had a lot more turn-downs——

Senator GRAMM. I am sure they have.

Ms. KIRTLEY. —because people are not willing to put their personal wealth at risk or their reputations or anything else, if it is

going to be a gotcha environment, if we cannot use the prudent-man rule, and if they perform their due-diligence, if we cannot rely on them to use their best business judgment.

Senator GRAMM. Thank you.

Chairman SARBANES. Senator Dodd.

Senator DODD. Just a comment because we have to get to the next panel.

I did not get a chance to get back to the scope issue, and I am respecting the Chairman's desire to move along here. What I will do is ask you to make some comments about it. Again, we drafted this legislation and the scope issue.

Mr. Copeland, looking at your own testimony, talking about the decision that Deloitte made, as the other firms did, the Big 5, and most recently, the recommendations of Mr. Volcker, regarding the consulting services and auditing decisions. The reluctant decision, using your language here——

Mr. COPELAND. Yes, sir.

Senator DODD. —to make those separations because of the perceptions and so forth.

First of all, what we have done in our legislation, or the proposal we have made, anyway, is to go back to the original proposal the SEC made on auditor independence and we tried to be sensitive about some of the very legitimate points that need to be brought in the taxation question, which I think is a very legitimate point in terms of conducting an audit, to be able to advise where the taxation issues are involved.

But I go back to the point, and I will ask all of you to comment on this if you want. When you are consulting, in a sense, in the contract or performing other functions within the consultative function, there is one client, in a sense. And that is, of course, the person who has hired you to do that service.

When the same firm is performing that function and simultaneously performing the audit function, which has, in addition to the person that hired you, the shareholder interest and others who will depend upon that information, it seems to me we run the risk of having the kind of collision of interests between the consultative function and the audit function.

And as we draft this one, we want to look at ways in which these nonauditing functions that are essential to performing the audit function are going to be included, or provide a mechanism for them to be included.

So, I would invite your comments on how we might do that and our suggestions that we propose in the legislation.

Mr. Chairman, I won't ask for a response to that at this particular moment, but I want to think that what the firms have done recently in response to this issue, and unilaterally voluntarily taking the decision to separate, is one based on a sound judgment and not just reacting because you think it is what the public wants you to do, but, rather, it makes sense to do.

Obviously, incorporating that in a legislative proposal so it is not left to the vagaries to move back into it once this passes us by, the public attention on this question, and to be reinstated later on.

So there is a need, I think, to codify in some way a decision on how we do make a distinction in those areas.

Chairman SARBANES. Why don't you submit to us any additional comments that you may have arising out of anything asked here at the hearing. We will continue to look to you to get your opinions on various issues that are being raised.

I just want to close with this observation. I would just commend it to you to think about.

As I said earlier, I think that we have a serious challenge on our hands. When the President of the United States is making jokes about the accounting profession, in a sense, even the implication is questioning whether it is a profession, essentially, is what it amounts to, that gives you some sense of where we are right now.

Obviously, you are very concerned about where we are going. But I want to say this to you. If we do not go somewhere where the structure and the system that is in place and its requirements are perceived and in fact, really address these issues and give us a real prospect that these situations are not going to reoccur, or will be significantly diminished, I do not think this thing is going to come to rest.

In the past when things have arisen, we had the Wheat Commission, the Cohen Commission, the Treadway Commission, and the O'Malley panel—we had some of those people in and of course, they were lamenting the fact that most of their recommendations never were implemented. Some did, but a lot of them did not.

And so, I think that if there is any sense that, well, we will draw the steam of this thing and it will relapse back into memory and there will be some changes, but they will be relatively minimal, I do not think that is going to happen.

This issue is going to continue to be an issue and will continue to ferment and to germinate until we reach a point where most people look at it and say, well, now, that is pretty sensible, what has now been put into place, and that ought to work.

I think for accountants, it means really kind of a reference back to these really quite impressive stories about the establishment of these large accounting firms, what they represented institutionally, and the standards they set, which of course, they have now drifted away from. And that, I think, is one of the challenges that is before us as we try to deal with this matter.

I would just leave that to you to think about as we try to move ahead and arrive at some resolution, which is obviously what we are focusing upon.

Senator DODD. Mr. Chairman, I was thinking as we were talking about these issues and the dual functions. You and I served with a Member of Congress whose name I won't reference who was elected years ago. He also had a law practice in his district. He had his district office as a Congressman——

Chairman SARBANES. Next door.

Senator DODD. Next door. And there were two doors. One says, Congressman X, Attorney At Law. And the other one said, Mr. X, Congressman X. When you opened up either door you got into the same room.

[Laughter.]

That doesn't happen any more, but it always struck me—maybe it has been reflected in my thinking back to those days of that very distinguished Member of the House.

Chairman SARBANES. You have been a very helpful panel and we appreciate your coming and giving us the benefit of your thinking.

Mr. CASTELLANO. Thank you very much.

Mr. COPELAND. Thank you.

Mr. GERSON. Thank you.

Chairman SARBANES. We ask the next panel to come forward.

[Pause.]

We are very pleased to have you here and we appreciate your patience through a long morning.

This panel consists of Peter Wallison, who is Resident Fellow and Co-Director of the Project on Financial Market Deregulation at the American Enterprise Institute.

Peter was previously a partner at Gibson Dunn and Crutcher. He was General Counsel at the Treasury Department in the early 1980's and then Counsel to President Reagan in 1986 and 1987. Sometime back, he was a Special Assistant to Governor Nelson Rockefeller and he was Counsel to Vice President Rockefeller during his tenure as Vice President.

Our other panelist this morning is Robert Litan, Vice President and Director of the Economic Studies Program at Brookings, and was Associate Director of OMB in the mid-1990's, Deputy Assistant Attorney General in the Antitrust Division of the Department of Justice from 1993 to 1995, and previously a partner of Powell Goldstein Frasier and Murphy, and many years ago was a staff member of the President's Council of Economic Advisers.

Gentlemen, we would be happy to hear from you. Mr. Wallison, we will go with you, and then Mr. Litan.

Mr. WALLISON. I thought we might start with Mr. Litan, if that is okay, Mr. Chairman.

Chairman SARBANES. Okay. That is fine.

Mr. Litan.

STATEMENT OF ROBERT E. LITAN
VICE PRESIDENT AND DIRECTOR
ECONOMIC STUDIES PROGRAM
THE BROOKINGS INSTITUTION

Mr. LITAN. Okay. Our time constraints are what? I think staff told us somewhere between 5 and 10 minutes.

Chairman SARBANES. Yes. Can you do that?

Mr. LITAN. Yes.

Chairman SARBANES. Your full statement will be included in the record.

Mr. LITAN. I will stay south of 10 minutes.

Chairman SARBANES. All right.

Mr. LITAN. Thank you, Mr. Chairman, for inviting us. I would like to make several background points.

Number one, markets and regulators already have engaged in a lot of self-correction in the wake of the Enron affair. Companies whose stocks were pummeled after Enron by investors are disclosing more, while the various gatekeepers who failed in Enron, the boards, the audit committees, the analysts, the rating agencies, and the auditors, have all tightened up.

Number two, knowing exactly how to fix the problems exposed by Enron is hard. The issues are complex, the facts aren't all in, the

experts do not all agree, probably including us, and there are pros and cons to every alternative that you consider.

Number three, precisely for these reasons, it is important that any legislation that Congress enacts preserve a maximum degree of flexibility and leave the details to the SEC.

With all of that in mind, I now turn to the four issues in my testimony. Number one is the improvement of accounting standards themselves. The accounting standard problem at Enron was basically the weak consolidation rule for all those special-purpose entities and you all know that FASB has basically since hopefully corrected that problem.

So the remaining issue on the table is what, if anything, to do about FASB itself and two particular problems it raises. One, it is slow; and two, you have undue political influence on FASB.

On the slowness issue, I have sympathy with those who have suggested that the SEC threaten as a backstop to step in by a date certain on a particular issue if FASB is not moving fast enough.

The harder issue is what do you do about political influence?

As I have talked to various people, some suggest nothing. They say, look, the FASB's rulemaking is like the EPA or OSHA or other kinds of rulemaking. It is inherently a political thing. So let politics intrude.

Now the response to that, though, is that there really is in my view an unequal balance of political interests. You have the firms and the accounting firms that have very narrow, very specific interests in particular rules. And then you have a very diffuse investor class that may not care about a particular rule, especially because they can sell the stock and they do not have to exercise any voice.

So, I think there is an undue political influence problem. The problem, though, is how to solve it. And I review all the options in my testimony and I say, ultimately, I do not think as long as the Congress oversees the SEC and the SEC oversees the FASB, that you are going to solve the problem at all.

The only theoretical way to solve it is to move standard setting to the international arena, international accounting standards. You can either replace GAAP with IAS or you can have the two compete against each other.

In my testimony, I come down on the side of competition. I suggest that we urge the FASB to narrow its differences on some key areas with IAS, and then quit. And then allow firms to choose one or the other.

They do this in Germany and I do not see any reason why we could not do that in the United States. And that could reduce the role of political influence because one of the things we see is that the market would punish the standard that is not delivering investor protection.

Chairman SARBANES. What is it they do in Germany? I missed that.

Mr. LITAN. They give you a choice between international accounting standards or U.S. GAAP, or even, I believe, German GAAP.

Chairman SARBANES. Except the international accounting people told us that the EU has now made the decision that by 2005——

Mr. LITAN. Correct.

Chairman SARBANES. —all countries will adopt the standards set by the International Accounting Standards Board.

Mr. LITAN. I am aware of that. And I am suggesting to you that in the United States, where we have had this war for many years, I think the only way to resolve it is to allow competition, but first, narrow the differences.

Senator DODD. What about the funding of FASB? It seems to me that is the politics of it. If you are going to be funded, 20 percent of it by the accounting industry and 80 percent by buying reports and papers that the accounting industry buys, if you move their funding scheme, the $20 million they need, to a different source, to give them more independence on that, then you seem to at least take out that kind of political influence.

Mr. LITAN. Yes, you could. Hopefully, this is not all coming out of my time. But in any event——

[Laughter.]

—on the funding, Senator, I do not think that ultimately solves the problem, with all due respect, because we can change the funding and I agree with you that it is probably better to have it funded in maybe the way you suggested. But, look, on very specific issues like expensing stock options or whatever, if Congress wants to get involved, there is nothing to stop it.

I think the big battles that we have seen over the last several years have not been funding issues. They have been because very specific interests have come to Congress, which then makes its views known, and there is no way to stop that, unless you basically take standard setting entirely out of the U.S. arena, or you allow competition and let the market punish the people that have the weaker standard.

Senator DODD. I will make sure this does not come out of your time.

Mr. LITAN. Sure.

Senator DODD. Just on that point. There have been efforts up here, for instance, in the debate over pooling and setting accounting standards, when there were threats made that Congress was going to legislate. Some of us up here bucked that very strongly and suggested, not that we necessarily agreed or disagreed with the accounting standard, but just the point that Congress somehow setting accounting standards was a bit frightening.

Mr. LITAN. Yes.

Senator DODD. We prevailed in that. That view that we should not bring these matters to a vote where, by a 51–49 vote, the Senate endorses a particular accounting standard. So where has the political influence produced a result? The stock option issue, is that the one you cite?

Mr. LITAN. I cite stock options.

Senator DODD. Okay.

Mr. LITAN. Yes. There is a survey article, actually, in the *National Journal,* that talks about Congressional involvement. The second issue is enforcement. Two ways to address enforcement—better monitoring and better incentives.

Now on better monitoring, the proposal *du jour* is the public regulatory board. And what Congress appears to be doing and in fact, Senator Dodd, you are author of a proposal to basically tighten up

Harvey Pitt's proposal. Make all the people independent, or most of them independent, and give it broader investigatory authority.

What I say in my testimony is that before you rush to adopt that plan, just stop and think about one alternative, and that is, have the SEC do the enforcement itself.

You can create the PRB and let them set the standards. But I survey the enforcement scene and I come from the Justice Department where I used to be and conclude that the Government does not contract out many enforcement jobs. This is inherently a Government function to enforce standards.

And so, I just raise the question for you whether it might not be a better idea to go, for example, to Senator Gramm's question about accountability, to go ahead and have the Government do this because the Government is the one that is accountable and give it the money to do it. That is basically where I come out.

Now what about incentives? We have the liability system, but that is a very blunt instrument, as we see. You drive a company out of business, it scares the hell out of everyone and sure, that is going to work. But you should want some more finely calibrated incentives.

What I suggest in my testimony is that auditor rotation and banning audit firms from doing unaudit work are not necessarily going to solve the incentive problem. I will give you a perfect example.

If you ban the nonaudit work and you only have an audit firm doing audit work, that is their only butter and they are working for management. They are at risk if they come down too hard at losing all their business on the only thing they are doing.

The ultimate nub of the problem is who they are working for. They are working for management. And that same thing is true of rotation. If you do rotation, if you have beauty contests every 4 years, and people are going to wink—all right?—in order to get a job. And you have that risk.

You have to change the people who are hiring them. I survey in my testimony all the kinds of people who can do this—the stock exchanges, the SEC, the PRB. I come down against each of them, because all of those options are just incredibly complex when you think about it.

The only one that makes sense is have the audit committee, with all its warts, have the audit committee be the one that hires the audit firm. That is where I come down.

Third point—competition in the wake of the decline of Arthur Andersen. If Arthur Andersen fails, we are going to have a less competitive auditing system. It is already highly concentrated. I have some data in my testimony on this. I can tell you from an antitrust point of view, this is not good. Audit services will go up, people have fewer choices. This is not a good outcome.

Do I have a clear solution for you? No. All I can come up with is, asking the SEC basically to encourage the private sector to hire second-tier firms, the ones right below the Top 5, and second, take a review of any of our regulations that may inhibit foreign firms from doing business in the United States, and maybe we can attract some foreign firms to try to get some more competition in this market. Those are the only two ideas I can come up with for a very difficult problem.

My last issue, the cutting-edge issues beyond Enron. Now, Peter is going to talk in a minute about the need for more nonfinancial disclosure. I want to tell you about a couple of other cutting-edge issues.

One of them is called XBRL. It is basically a project that the AICPA has started with a bunch of accounting firms and other real firms to put data tags on all the kind of information you see in financial statements, so that people who use the Internet will be able to manipulate data much more easily than they do now.

They will be able to search, for example, and find a very specific category of firm. They cannot do that now with the way financial statements are currently done. And the way to advance XBRL, I suggest, is to have the Edgar filings, which are now done by every corporation, make them be in XBRL by a certain date, and you will vastly increase the ability of investors to play with analyzed data.

I also like the Administration's proposal to require more significant intra-quarterly disclosures. I think that is a good idea. Also, I like the mandated disclosure of sales by insiders and so forth.

But I leave you with the following observation. That in the age of the Internet, there is no reason why, ultimately, we cannot move to much more frequent reporting than quarterly. Monthly, even weekly.

I know it sounds crazy. But I want to tell you, everyone here, or a lot of your witnesses, have complained about earnings management. Everybody's trying to hit those quarterly numbers. I haven't heard one credible idea to attack the problem, to reduce earnings management.

I hold out one hope. If we had more frequent reporting, people would attach a hell of a lot less importance to the quarterly numbers. They'd be focusing on the weekly or the monthly numbers, and people would forget about the quarterly numbers. Frankly, you cannot predict——

Senator DODD. Quarterly numbers.

Mr. LITAN. Whatever. You cannot predict weekly or monthly numbers. The analysts will give up and, frankly, you will get so much information out there, that people will pay less attention to it and I predict there is a chance that the problem will go away.

The final point is plain English. Everybody wants plain English in the financial statements. It is a great idea. But all I want to remind you is, you can have all the editors you want at the SEC and all the plain English in the front, which, by the way, I am for. I am all for plain English.

I just want to tell you, it is not going to prevent future Enrons.

That is the end of my testimony.

Chairman SARBANES. Very good. That was very helpful and very well done.

I just might observe—we do hourly numbers and have the stock markets open 24 hours a day.

Senator DODD. Right.

Chairman SARBANES. We can keep everything in a total frenzy all the time.

Mr. LITAN. Exactly.

[Laughter.]

Chairman SARBANES. Just feeding off of itself all the time.

[Laughter.]

Everyone will be absolutely hyperactive.

Mr. Wallison.

STATEMENT OF PETER J. WALLISON RESIDENT FELLOW AND CO–DIRECTOR PROJECT ON FINANCIAL MARKET DEREGULATION AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. This is the CNBC proposal, I suppose.

Chairman SARBANES. Yes.

Mr. WALLISON. Well, Mr. Chairman, and other Members of the Committee, it is a delight to be here, and to have the opportunity to present this testimony.

Bob has covered really all of the issues that are currently in the press and are of interest to the Members of the Committee as you attempt to legislate in this environment. So, I won't cover any of those.

I would like to say, though, that when you are asking questions of both of us, I would be happy to take questions, too, on these Enron-related issues. And you might find, surprisingly, that someone from Brookings and someone from AEI can agree on a lot of these things, although there are some areas where I have a different view from what Bob has expressed.

My testimony today, however, will talk about the future, in large part because I believe much of the current debate about the quality of GAAP and how it was enforced—or whether it is sufficiently enforced—may be beside the point.

The fact is that GAAP accounting is becoming increasingly irrelevant for financial disclosure and we must begin to work on supplements and alternatives. I will try to explain why this is so and discuss some of the ideas that are necessary to bring financial disclosure into the new economy that we are creating here in the United States. This could get just a little bit technical, but I will try to keep it as short as possible.

The reason our financial disclosure system must change is that we have now entered the information or the knowledge economy, and intangible assets have become the primary means by which our economy creates value.

According to some estimates, 80 percent of the value of companies listed in the S&P 500 is attributable to their intangible assets. Now what are intangible assets and what is the significance for financial disclosure of their coming to dominate the assets of American companies?

Computer software and pharmaceuticals are two examples of goods that are, in one sense, manufactured, but in a much more important sense are the product of human knowledge and skill rather than machinery and equipment.

In other words, most of the value created that is added to the plastic of a computer disk or the chemical in a pill is added by the knowledge of the employees who have the skills and the imagination to conceive and develop the computer software programs or the new drugs.

The knowledge assets that conceive and produce these products are intangible because they cannot be touched or seen and they are

assets because they are instrumental in generating cash flows for the companies that use them.

Other intangible assets include such things as patents, trade secrets, computer programs, trademarks, brand names, and even, and this is quite interesting, customer loyalty or satisfaction.

Here, then, is the difficulty.

The vast majority of the value created in the United States today is produced by intangible assets. But these assets do not appear, and in many cases, cannot appear, on corporate balance sheets. It is important to note that this problem cannot be solved by changing GAAP accounting rules. GAAP relies on costs—of land, equipment, rolling stock—to establish values, and there is no known way to place value on knowledge assets.

In fact, since in many cases they exist only in the heads of the employees of these companies, these assets are not even owned by the companies that make use of them for generating cash flow or profits.

That is why, after the advent of the knowledge economy, the market value and balance sheet value of public companies began to diverge. So that, in the year 2000, the market values of public companies were six times greater than their balance sheet net worth. This was not true, incidentally, in the late 1970's, when it was just about 1:1.

Obviously, investors were seeing something in these companies other than what appears on their balance sheets and it seems reasonably clear that what they are valuing are the companies' intangible assets.

Now it might be objected that balance sheet values do not really matter, that in the knowledge economy what investors are looking at are earnings, and that the price earnings ratios of public companies are what are important.

Why is that not sufficient to give investors all the information they need about companies?

The answer is that, once again, the inability to value intangible assets or determine whether a company is creating value in the form of intangible assets, or destroying it, can distort income statements, making price earnings ratios and other similar comparisons unreliable.

A very good example is furnished by AOL. During the years 1994 through 1996, AOL spent a huge amount of money on acquiring customers by sending out computer disks and extensive advertising. AOL treated these customer acquisition costs as an investment and capitalized on them. It argued that it was creating a valuable customer base, which would be, of course, an intangible asset.

When a company capitalizes its costs, there is no immediate impact on earnings, of course, and the SEC claimed that this was misleading. The SEC's argument was that because AOL capitalized these costs, it was able to show profits in each of the years 1994 through 1996, but if it had treated them as expenses, it would have shown losses.

In 1997, under pressure from the SEC, AOL changed its accounting treatment, and restated its 1994 through 1996 financial statements, so that it expensed these customer acquisition costs. Was this the right treatment?

The answer in the light of later developments is clearly no. AOL, as we all know, turned out to be a great success, largely because it accumulated a huge number of customers before anyone else. In other words, AOL's customer acquisition costs were investments since they produced a very large, profitable, and ultimately, market-dominating customer base, which is a huge intangible asset.

This also means that investors who were sophisticated enough to recognize this were correct in giving AOL an enormous price earnings ratio during this period. The commentators who just looked at historic price earnings ratios and did not consider that AOL was building a huge intangible asset were wrong when they said that this company and a whole lot of other companies in the knowledge economy were "overvalued."

We hear that even today.

They failed to grasp the significance of an intangible asset that was not on AOL's balance sheet.

It seems clear, then, that our economy, as it comes to rely increasingly on intangible assets as the source of company values, must have some way to assess the quality of these assets. We must recognize that GAAP accounting can never do this. As the AOL case shows, it may in fact distort perceptions of value.

This is not a healthy situation. If financial statements do not allow investors to understand the real value of a company, this creates risk. And when risk is created, it raises the cost of capital, promotes volatility, and ultimately distorts capital allocation.

The accounting profession has recognized this problem and has been working on it for years. Bob and I, neither of us accountants, wrote a book called "The GAAP Gap," which covers what the accounting profession has been doing over the years on these issues.

One answer that has achieved some currency is the development of metrics or indicators that would allow investors to get some sense of the value of the intangible assets that a company has created, and whether these assets are becoming more or less valuable.

The organizations working on this include most of the major accounting firms, Financial Accounting Standards Board, and on an international level, the Organization of Economic Cooperation and Development. But up to now, progress has been slow.

First, companies are concerned about proceeding down this road. They say it may provide information helpful to their competitors. They are afraid that it may result in legal liability. There is some merit in these concerns, but they may be somewhat exaggerated. Congress can do something about that.

Also, companies do not see any direct financial benefit in incurring the costs necessary to develop the necessary indicators and the information that these indicators will disclose. But there are several areas where businesses are already cooperating in activities that are closely related to the development of these indicators and would be useful to investors.

Benchmarking, supply chain standardization, and indicators developed for the internal use of management, which many companies now have, are examples of this.

In addition, there is data, and this is extremely important, that indicates that increased disclosure can have the effect of lowering

capital costs. This stands to reason since more information reduces uncertainty and, hence, volatility and risk.

If companies can be convinced of this effect, it could produce a virtuous circle in which they offer higher quality disclosure to reduce their capital costs.

The issue for policymakers is how to stimulate development in this direction. The solution, however, is not to mandate indicators, even if they already existed.

Indeed, action of this kind by the SEC would be exactly the wrong way to get this process started. As we have seen in the past, mandated SEC requirements very quickly produce boilerplate disclosures and stifle innovation. On the other hand, the SEC could perform a valuable role without issuing mandates. It could convene experts, accountants, and business people, encourage voluntary action, deal with objections that are raised, seek solutions that attract support—emphasizing always that investors need information in order to make rational choices.

I would hope that the Committee would include in any post-Enron legislation language that will encourage the SEC to move in this direction.

Mr. Chairman, that concludes my testimony. Thanks very much.

Chairman SARBANES. Thank you very much.

Who do you think should set the standards? The SEC? The professional group? Some independent body?

Mr. WALLISON. I am strongly of the view that the Government should have as little to do with setting accounting standards as possible. And I am somewhat concerned even about the idea that the Committee's proposal will result in an independent body that is supposed to set auditing standards, ultimately reporting to the SEC. This might give the SEC control over accounting standards.

There is already too much opportunity for political involvement in setting accounting standards, and to the extent that this opportunity is increased in any way, I think we endanger the confidence of the investing public in the validity of accounting standards.

Chairman SARBANES. Well, who do you think should set the accounting standards?

Mr. WALLISON. An independent body, members of the accounting profession. How that is financed, I think can be worked out.

Chairman SARBANES. That is an important question. Do you think it should be financed in an automatic way?

Mr. WALLISON. Yes.

Chairman SARBANES. I do not know. You can think of different ways to do that, but where fees are levied and the people upon whom the fees are levied have no choice in the matter. They have to pay the fee, whether it is to be listed on an exchange, whether it is to be an accounting firm, whatever.

Mr. WALLISON. Yes. I think fees paid by the public companies, contributions by accounting firms. There could be a number of ways to provide for financing for this organization. But it has to be isolated, insulated insofar as possible, from politics.

I should mention that I have done a little bit of work studying the Japanese economy. They have a terrible accounting system in Japan and it is one of the reasons why they have such serious banking and nonperforming loan problems.

They cannot even tell when a loan is nonperforming. And one of the reasons their accounting system is so bad is that accounting principles have been set by legislation in some cases. You cannot legislate truth. How accounts are presented must be a judgment made by experts.

Chairman SARBANES. Do you have a view on the super-majority requirement at the FASB in order to put forward, to promulgate standards?

Mr. LITAN. Not a strong view. I think the most important thing, as I said in my testimony, is that we get competition. IF FASB were truly competing with IAS, you would see it act more quickly, and actually, I think it would reduce political influence for the reasons I talked about, because the market would punish the standard that is perceived as a weaker standard.

Chairman SARBANES. I take it, then, what is your view down the road of moving to one international accounting standard and one international accounting standard board?

Mr. LITAN. Okay. My view is that it is Utopian. Now, I know, even with the best of leadership, that is, with Paul Volcker and David Tweedy, they may come up with the world's best standard.

But I think what is likely to happen is that because the international standards, as you know, are heavily discretionary, and our system is much more rules-based, I predict what would happen if we ever got to IAS as the single standard for the United States, is that because it is so discretionary, there would very quickly be a demand within the United States to have interpretive rulings, whether by FASB or whatever other body the SEC is talking about, on what does the IAS mean by Rule No. 214 and 215, and so forth.

I think what would happen is that the international standard would fragment. You would end up with the U.S. version of the international standard, conceivably a European version, and we would be right back to where we are now. So, I do not think it is a stable equilibrium.

By the way, there are people who disagree with me. There are people in the accounting profession who think that in a world of one single standard, we will see the demise of FASB and we won't get this fragmentation. But if we end up with that world, and only one single standard setter, all the problems you have with FASB being slow, not up with the times and so forth, seem to be multiplied in spades at the international level.

Just look at the Basel Committee that sets capital standards. They are now in their either third or fourth version of a revision of a standard that now is, what, 3 or 4 years old and it will probably be another 3 or 4 years before they ever come out with one. That is what will happen if you go to an international standard.

Chairman SARBANES. Mr. Wallison.

Mr. WALLISON. It seems to me the most effective way for us to solve the problem of international accounting standards versus GAAP accounting is for the two systems to compete and compete in the same market. This would be a good market for them to compete in.

I am very reluctant to have any set of standards set more or less bureaucratically for the entire world. The problem is that accounting is used for a number of purposes, not just for investors. It is

also used for lenders and other people who interact with companies. And what we have to have is a system that permits change.

One of the ways you bring about change and innovation is through competition.

So, I would like to see two different sets of accounting standards competing here in the United States. I think the likelihood is that neither will ultimately triumph and we will continue to have two, one of which serves one set of purposes and one serves the other.

Mr. LITAN. By the way, there was a paper yesterday presented at a conference at AEI by a Wharton professor, Christian Leoz, who basically showed that in the never market in Germany, they have had the choice now for a number of years, and it is roughly 50/50, and it is been stable for the last several years, where issuers basically go right down the middle in terms of which they choose. And that is actually not a bad outcome.

Mr. WALLISON. Actually, the interesting thing about that, Mr. Chairman, if I could add to it, is that the bid asked spreads between companies in that market are no different for those that have chosen GAAP as opposed to those who are using IAS. And that suggests that the disclosure that is provided by both is equivalent from the standpoint of investors.

Chairman SARBANES. Mr. Litan, I want to be sure that you would leave enforcement with the SEC. Is that right?

Mr. LITAN. You mean the oversight function?

Chairman SARBANES. Yes.

Mr. LITAN. I think that the enforcement function is inherently a governmental function.

Now, I know we have the NASD and we have examples of self-regulatory agencies, but they are the exception rather than the rule.

Chairman SARBANES. Do you think that the NASD is a good exception?

Mr. LITAN. It improved after we prosecuted it when I was at the Justice Department. Collusion—and by the way, this is a big problem in any private-sector solution because we have such a concentrated industry. You go too far in a private direction and you have a collusion problem. But I think, ultimately, we are talking about enforcement. That is a Government function, it sounds like to me. Who was it? Dick Darman says, "If it walks like a duck, it is a duck." This enforcement thing is a duck. It belongs to the SEC.

Chairman SARBANES. Do you have a view on that, Mr. Wallison?

Mr. WALLISON. Yes. I agree with the enforcement point. I also think that it is necessary that there be a separate organization that regulates the auditing function and sets rules for it.

I think accountants and nonaccountants can be members. That is an area that is suitable for some separate regulation by a nongovernmental or a quasi-governmental organization reporting, in that case, I think appropriately, to the SEC.

Mr. LITAN. And I agree with that. The rule setting is separate from the enforcement, and I think that is what we are both saying.

Chairman SARBANES. Well, you have been very helpful. It has been a long morning. We appreciate your patience in staying with us. I hope we can be back in touch with you to draw further on your expertise as we work through this problem.

Mr. WALLISON. Thank you.

Mr. LITAN. Thank you.

Chairman SARBANES. Thank you.

This hearing stands adjourned.

[Whereupon, at 12:48 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman. I am glad to be back for another hearing on this very important topic.

Last week, I joined with Senators Dodd and Corzine at the introduction of the Investor Confidence in Public Accountability Act of 2002. I am proud to be an original co-sponsor of this bill because I think it offers some common sense solutions to the problems that we have discussed in the first six hearings on this topic and that we will continue to examine in this Committee up to the Spring recess.

As this Committee has investigated investor protections and the accounting industry in light of Enron and other troubled companies, time and time again, we have heard about the need for an enhanced oversight mechanism for the auditing profession. We have also heard about the potential for conflicts of interest when accounting firms offer both auditing services and consulting services to the same companies. We have heard about the need for financial independence for an industry oversight board and we have heard about the need for financial independence for the Financial Accounting Standards Board (FASB).

In addition, I suspect there are few who would argue that the SEC has enough staff and enough money to do its job. And I think that all of us would agree that increased financial disclosures and additional information about stock sales by corporate leaders benefit American investors.

These are the issues that I have teamed up with Senators Dodd and Corzine, as well as with Senators Johnson and Boxer to address in our bill. I look forward to working with them and to working with the Chairman. The Chairman has been a true leader in the Senate on this issue, holding the most thorough examination of the topic at hand.

As I have said before, our hearings don't necessarily make the headlines with subpoenas sent to Ken Lay and Andrew Fastow, but the work we do here is what is going to make the biggest difference at the end of the day. We are going to move important comprehensive reforms that will ensure best practices are followed in the accounting industry, reforms that will better insulate oversight and standard setting boards from industry and political pressure, and most importantly of all, reforms that will give investors more thorough and accurate information about the financial health of companies so they can make better investment decisions.

That is the task before us and I look forward to working with all of my colleagues on both sides of the aisle to enact this bill this year.

Again, I thank the Chairman and I look forward to hearing from our witnesses.

PREPARED STATEMENT OF JAMES G. CASTELLANO, CPA

CHAIRMAN, BOARD OF DIRECTORS
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)
MANAGING PARTNER, RUBIN, BROWN, GORNSTEIN & COMPANY, LLP

MARCH 14, 2002

Thank you, Chairman Sarbanes, Ranking Member Gramm, and the other distinguished Members of the Committee for permitting me to testify before you today on accounting and investor protection issues raised by the collapse of Enron and other public companies. I am Jim Castellano, Chairman of the Board of the American Institute of Certified Public Accountants. Enron and its aftermath have clearly shaken public confidence in the accounting profession, in the quality of financial reporting, and in the reliability of our system of public company disclosure. It has brought us to the cusp of an historically significant moment when the need emerges to give thoughtful and careful consideration to systemic reform.

Commitment to Reform

The AICPA is deeply committed to maintaining and to improving the quality and reliability of financial disclosures. The public demands nothing less. In order for our capital markets to function effectively and for our economy to allocate resources efficiently, it is essential that business enterprises report accurately and fairly to investors *and* that investors perceive that they do so. Our economy needs both the fact and the appearance of credible financial reporting. To that end, our paramount concern is the restoration of public confidence in the quality of financial reporting and in the accounting profession.

I am here to assure the Committee that the AICPA will support meaningful and appropriate reforms, and has been both an advocate and a catalyst for necessary

change throughout its history. We recognize the importance for elected leaders to act responsibly in order to do what they can to prevent a business failure on the scale of Enron from happening again. In doing so, however, rapid action should not be a substitute for principled reform. We believe the real value of any new public policy affecting our profession must be assessed by asking four basic questions:

1. Will it help investors make informed investment decisions?
2. Will it enhance audit quality and the quality of financial reporting?
3. Will it help restore the confidence in the capital markets, our Nation's financial reporting system, and the accounting profession?
4. Will it be good for America's financial markets and economic growth?

Using these four criteria as benchmarks, the AICPA will work with the Committee, the Congress, the SEC, and the FASB to continue to develop meaningful and appropriate reform.

Context for the Accounting Profession

Each year, many CPA's who are employed by public companies prepare the financial statements for the 17,000 companies that are registered with the SEC, and many CPA's audit those financial statements. In cities big and small, CPA's prepare and audit financial statements for tens of thousands of small, medium, and large companies to meet Federal, State, local, and other commercial requirements. The men and women preparing these filings and auditing these financial statements do so with the utmost integrity and fairness. Unfortunately, it is often the case that the significant role they play in the U.S. capital markets only gets recognized when a business fails.

The AICPA and its members are committed to the goal of assuring that our markets remain the best in the world. Our paramount concern is the restoration of public confidence in the quality of financial reporting and the accounting profession. To that end, we believe the public interest requires a comprehensive approach designed to foster improvements in the quality of audits, the reliability of financial disclosure, and the efficiency of our capital markets.

Modernizing the Financial Reporting Model

To keep pace with today's fast moving economy, the system of financial reporting must be modernized. Economic change has outpaced the corresponding accounting for such change. Intellectual capital has become the greatest engine for corporate growth. Yet, accounting is still based on hard assets—physical plant and related items for producing goods. Even companies producing tangible goods have become highly dependent on intangible sources of revenues and competitive advantage. Knowledge work has become the key to corporate effectiveness.

The accounting profession was first among those convinced that the accounting model needed to be modernized. From 1991–1994, a Special Committee of the AICPA studied the state of business reporting.[1] The Special Committee's greatest achievement was its research on the needs of investors and creditors. The research showed that investors have many unmet informational needs. Figuratively speaking, because corporations seek capital from investors and creditors, investors and creditors are customers of the corporation's sale of securities. Monetary exchanges do not take place without information and, the better the information about a prospective purchase, the better the purchaser's chance to make a satisfactory pricing assessment. Putting the same point in terms of investors' purchases of securities, the better the information investors have, the lower the risk of poor investment or credit decisions.

In the broadest sense, if we are going to modernize the accounting model, we must focus on the following areas:

- First, a broader "bandwidth" of information encompassed by the business reporting model.
- Second, different distribution channels, namely, the Internet.
- Third, increased reporting frequency, with an ultimate goal of on-line, real-time reporting.

To achieve these fundamental improvements to our system of investor information, the accounting profession needs the best and brightest minds with a variety of interdisciplinary skills. As you will hear from my fellow panelist we must be careful to avoid quick fixes that would deprive the profession of this talent.

[1] AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus,* 1994.

Conclusion

We will continue to work with the Committee, the Congress, and the regulators to develop meaningful and appropriate reforms. At the beginning of my remarks, I identified four basic questions that we suggest must be asked to assess any new public policy. In that vein, we all must consider whether any reform under consideration—while well-intentioned—will have unintended consequences that outweigh any benefits it may bring to the system.

We look forward to participating in this healthy debate in the days and weeks ahead.

PREPARED STATEMENT OF JAMES E. COPELAND, JR., CPA

CHIEF EXECUTIVE OFFICER, DELOITTE & TOUCHE, LLP

MARCH 14, 2002

I am the Chief Executive Officer of Deloitte & Touche, LLP, one of the five largest accounting firms in the country. I am appearing here today not only in that capacity, but also on behalf of the American Institute of Certified Public Accountants (AICPA). I am a member of the AICPA, as are many of Deloitte & Touche's partners and professionals, and Deloitte is proud to be a member of the AICPA's SEC Practice Section.

We at Deloitte have the same perspective as our colleagues in the profession and the AICPA with respect to the many proposals currently under consideration, and so my remarks today are intended to provide the Committee with the perspective of large firms and the AICPA, not simply Deloitte.

In the wake of Enron's collapse, public attention has focused on ways to improve the effectiveness and independence of financial statement audits of public companies. That attention is welcome. America has the most secure and reliable capital markets of any nation—an achievement that should not be ignored—and we should continue to try to strengthen a system that serves as a model for the world.

But the current situation presents danger as well as opportunity. The danger is this: In the rush to enact reforms in response to perceived flaws in the system, we risk losing sight of the fact that the proposed reforms come with *consequences*—intended and unintended—some of which will diminish the stability and certainty that characterize our markets and that permit them to be the engines of economic growth. That is why we must think through the consequences of the proposals currently under consideration before implementing sweeping changes.

SEC Chairman Harvey Pitt has proposed the creation of a new regulatory organization, under the SEC's oversight. The new organization would be dominated by individuals from outside the accounting profession and would be empowered to conduct disciplinary investigations and operate the program that ensures the quality control of firms that conduct audits of public companies. This regulatory model would effectively replace the profession's system of self-regulation in these areas with public regulation and should be fully explored.

We believe the time is right to create new systems for performing quality reviews of the practices of public company auditors and for disciplining those auditors. Accordingly, we support moving from a system of self-regulation to one of public regulation for these important processes. We further believe that these processes should be subject to SEC oversight.

Other proposals would effectively remove auditors from the audit standard setting process and burden the new regulatory organization with standard setting. Such a change would be a mistake. Audit standards should be set by professionals who understand auditing, not by lay people who have no practical experience in auditing.

I would like to say a few words about several specific proposals that many regard as quick fixes to the problems they perceive with the profession.

One proposal currently being debated is the periodic rotation of audit firms. The AICPA already requires that the lead audit partner on every public company financial statement audit be rotated at least once every 7 years,[1] an approach that ensures a fresh look at a company's books at regular intervals. But requiring the rotation of entire *firms* is a prescription for audit failure. Rotation of audit firms would result in the destruction of vast stores of institutional knowledge and guarantee that auditors would be climbing a steep learning curve on a regular basis. It would

[1] This requirement does not apply to firms that have less than five SEC audit clients and less than 10 partners because the benefit of the rotation is greater for larger firms auditing large companies.

result in increased "start-up" costs for the auditor, the company being audited, and the public, as every few years an entirely new group of auditors would have to be educated and brought up to speed on the intricacies, and legitimate accounting issues, presented by a given company's operation.

And it would expose the public to a greater and more frequent risk of audit failure since studies show that audit failures are more likely to occur during the initial years a firm is auditing a new client. In fact, at least one study has identified a link between financial fraud and a change in auditors.[2]

Many groups have studied this very issue and concluded that audit firm rotation is a bad idea. The Commission on Auditors' Responsibilities, the SEC's Office of the Chief Accountant, the Public Oversight Board, the General Accounting Office, and the Committee on Sponsoring Organizations of the Treadway Commission have all determined that the costs of mandated firm rotation would exceed any of the possible benefits.[3]

Limiting an auditor's ability to become familiar with the client's business would also make it easier for reckless management to mislead the auditor. Regardless of how independent an auditor is, the likelihood of fraud will increase if the auditor lacks institutional knowledge and must, therefore, place undue reliance on the client's guidance and representations. Mandating audit firm rotation will also make it easier for companies to disguise opinion shopping by enabling companies to portray a voluntary change in auditors as obligatory.

The Enron case illustrates the type of complex financial structures that auditors often confront. It would, therefore, be ironic were Enron used to justify any proposal, including audit firm rotation, that would result in auditors being less informed, less educated about the client's business and operations, and less equipped to conduct a thorough audit. Particularly in today's complex business environment, depth of knowledge is essential to performing an effective audit and making sound judgment calls regarding difficult accounting and reporting issues. Despite the superficial appeal of the idea, audit firm rotation likely would result in an increased number of audit failures.

A related proposal involves a ban on the so-called "revolving door"—situations in which an auditor goes to work for an audit client. The SEC and the Independence Standards Board considered the wisdom of imposing a "cooling off" period before an auditor could accept employment with a former client. Both concluded that such a rule would impose unwarranted costs on the public interest, on public companies, and on the profession. Indeed, limiting the career opportunities of accountants would make the profession less attractive and make it more difficult for firms to hire qualified people. Studies have shown and our experience is that existing safeguards, including the mandatory rotation of audit partners as well as the additional procedures that are put in place when a member of an audit team joins a client, are effective in addressing so-called "revolving door" situations.[4]

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[2] *See* Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting: 1987–1997: An Analysis of U.S. Public Companies* (March 1999).

[3] *See* The Commission on Auditor's Responsibility, *Report, Conclusions, and Recommendations* (AICPA 1978) at 108–09 (finding that the costs of mandatory audit firm rotation exceeds the benefits and suggesting that many of the benefits of audit firm rotation can be achieved through firm personnel rotation); SEC Office of Chief Accountant, *Staff Report on Auditor Independence* (March 1994) (indicating that a periodic change in engagement partners responsible for audits provides a good opportunity to bring "a fresh viewpoint to the audit without creating the significant costs and risks associated with changing accounting firms"); *Strengthening the Professionalism of the Independent Auditor,* Pubic Oversight Board Advisory Panel on Auditor Independence (1994) (agreeing with the Cohen Commission's findings concluding that rules mandating audit firm rotation are impractical from a cost/benefit perspective); Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting: 1987–1997: An Analysis of U.S. Public Companies* (March 1999). It has been noted that countries that have legislated rotating audit firms, such as Spain, Greece, and Canada, have generally returned to a traditional market system, whereby companies are free to maintain or change audit firms as they see fit.

[4] Current guidance on employment relationships requires, among other things, that the former practitioner cannot influence the firm's operations or financial policies; have a capital balance in the firm; or have a financial arrangement, other than one providing for regular payment of a fixed dollar amount, which is not dependent on the revenues, profits, or earnings of the firm. In addition: When an auditor is considering employment or approached by the client regarding employment, he or she must be removed from the audit engagement; if an auditor accepts employment, the firm needs to review the work of that auditor to assess whether the appropriate skepticism was exercised; if an auditor accepts employment, a determination needs to be made as to whether the audit plan should be revised to eliminate the risk of circumvention; in situations where a former practitioner joins the client and will have significant interaction with the audit team, the firm needs to take appropriate steps to ensure that the audit team has the stat-

Continued

Another proposal currently being debated involves placing increased limitations on the scope of services that firms may provide to their audit clients. Just last month, my firm announced that we will further separate our management consulting practice—a step we took reluctantly, but one we deemed necessary to address the market's concerns about the perception of auditor independence and help restore investor confidence in the profession. All of the other Big 5 firms, in one way or another, have taken a similar approach. But this is our model and it may not be right for other firms.

Further limiting the scope of services firms may provide to their audit clients is a bad idea. It is a bad idea because it will *not* make an audit team any more independent, but it *will* make the team less competent.

In conducting an audit of the financial statements of a company, you obviously need good accountants and auditors, but you also need technical experts. For example, in auditing the financial statements of a company like Enron, you would need experts in market trading controls and information technology. An audit team that does not bring with it the technical knowledge and skills necessary to understand the company's business will not be able to perform a competent audit.

Why would additional limitations on the scope of services make it more difficult to bring specialists into the auditing process? Because these experts are not auditors. They do not devote their careers to audit support work. If we asked them to abandon their consulting work and do nothing but audit support work, we would not be able to retain them. The best and the brightest seek positions that will allow them to develop their expertise, to learn, to work on cutting-edge issues, and few will choose to remain in jobs that offer limited opportunities and seriously restrict their professional development and employment options.

We do not believe that scope-of-services restrictions would have prevented Enron and will not prevent the next business failure. In fact, several recent studies have demonstrated that there is no correlation between the provision of nonaudit services and audit failures. In not one of the audits considered by the POB's Panel on Audit Effectiveness did the Panel identify any instances in which nonaudit services had a negative effect on audit effectiveness.[5] To the contrary, the Panel's reviewers concluded that in about one-quarter of the audits studied, those services "had a positive impact on the effectiveness of the audit." As to the remainder, "the reviewers either were neutral regarding the effects of nonaudit services on audit effectiveness or concluded that the services had no impact on audit effectiveness." Investigators at the University of Southern California and Texas A&M International University, in their study, concluded that concerns that nonaudit services impair auditor independence are unfounded.

The current search for fixes, for ways to prevent another Enron, is fitting and proper. The failures of American businesses often teach as much as their successes. We should learn from what has happened and make changes that provide meaningful opportunity for improving the quality of audits.

Thank you very much.

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ure and objectivity to effectively deal with the person and his/her work; and if the auditor joins the client within 1 year of disassociating from the firm, the audit must be reviewed separately by a professional who previously was not involved in the audit in order to make sure the audit team exercised the appropriate skepticism.

[5] *See* The Panel on Audit Effectiveness, *Report and Recommendations,* at 113 (August 2000). The Panel on Audit Effectiveness consisted of eight members appointed by the Public Oversight Board in October 1998 at the request of SEC Chairman Arthur Levitt. The Panel was charged with evaluating the performance of public company financial statement audits and assessing whether recent trends in audit practices served the public interest.

PREPARED STATEMENT OF WILLIAM E. BALHOFF, CPA, CFE

CHAIRMAN, EXECUTIVE COMMITTEE
AICPA PUBLIC COMPANY PRACTICE SECTION
SENIOR AUDIT DIRECTOR, POSTLETHWAITE & NETTERVILLE, A.P.A.C

MARCH 14, 2002

In my role as Chair of PCPS, and as a partner in a local CPA firm, I am here today to represent the opinions of small firms located in towns and cities all across the United States. I have two main topics I would like to discuss with you: (1) how restricting the performance of nonaudit services would adversely impact small business owners and our ability to meet their very diverse needs and (2) how any new legislation that would affect the accounting profession must take into account the need for small accounting firms to recruit new talent.

My firm performs over 150 financial statements audits of which only three companies are public registrants. However, the majority of our PCPS members do not audit public companies. Still, we believe any legislation that imposes new scope-of-service limitations on auditors will have unintended consequences that adversely affect small CPA firms, the small businesses we serve, and ultimately the public.

History shows that new legislation by Congress is highly likely to become the "template" for parallel legislative or rule changes at the Federal and State levels that would directly affect small CPA firms and the small business clients we serve. In particular, as auditors who provide services to small businesses, we are often subject to rules established by State accountancy boards, the U.S. Department of Labor, the General Accounting Office, and State and Federal bank regulators. These bodies traditionally follow the lead set by Congress and the SEC in adopting new laws or regulations for auditors of public companies.

Indeed, after the SEC issued new rules on auditor independence in late 2000, the GAO followed suit with its independence standards earlier this year. The GAO requirements not only duplicate, but in some cases exceed, the new SEC restrictions on nonaudit services. I have brought with me, and will submit to the Committee, a letter we received from one of our small CPA firm members, a sole practitioner located in Denton, Maryland, a small rural community on the Eastern Shore. In his letter, this CPA explains that, as a result of the new GAO restrictions, firms such as his that audit clients subject to GAO regulations are required to assign separate personnel to perform nonaudit work, such as the preparation of income tax returns. Of course, as a sole practitioner, he has no "other personnel" to assign. He explains that the practical result is that he will either have to give up his solo practice and associate with a larger firm, or tell his GAO clients that they will now need to hire a second firm to perform either their audit or tax work—an alternative that, for many such clients, is not economically feasible nor justifiable.

Small businesses have long depended on small accounting firms to provide much more than auditing services. The CPA serves as the "trusted advisor" of the small business owner. For example, a CPA firm will often assist a small business as it is just starting out, providing guidance on setting up its record-keeping systems, providing tax and estate planning and making suggestions to help make its business more successful. The CPA also helps the business as it grows. I have one client that had decided to expand its business by adding another location in the local area. After asking questions concerning its projected increase in sales, changes in gross margin, and expected competition, as well as the impact on its financial statements, I helped the client develop a financial model to address these issues. The bottom line was that the company decided that, if it went forward with its plans, it would risk the very financial stability it had taken decades to build. This is just one example that displays the important role CPA's play in providing small businesses with information necessary for them to maintain their financial strength.

As I am sure you will agree, successful small businesses are a cornerstone of Main Street America. It is likely that, in many cases, if the CPA does not have the ability to act as the "trusted advisor" to his or her clients, many small businesses will simply not seek the input of other third-party professionals. It is vital, both for the small business person and for the survival of many thousands of small accounting firms, that current laws not be changed in a manner that is insensitive to these concerns.

My second concern is the effect new legislation might have on the ability of our profession to retain personnel and attract new entrants into the profession. This is already an area of great concern for firms of all sizes, and research undertaken by the profession has uncovered alarming trends.

Specifically, studies completed by my committee confirm that we are experiencing significant difficulty attracting students into accounting programs and the profession. For example:

- The number of accounting graduates in the United States has decreased from 60,000 to 45,000 from 1995 to 2000.
- The number of students enrolled in accounting programs has declined from 192,000 to 143,000 from 1995 to 2000.
- The number of candidates sitting for the CPA exam has declined by 33 percent from 1990 to 2001.

Our surveys show that the major reason fewer qualified students are studying accounting is because the profession is perceived as narrow and focused too much on historical "numbers," whereas other business careers are seen as much more rewarding and exciting. It is critical that we change this perception and continue to attract young, bright minds to the accounting profession. Any of our current efforts to recruit students to the CPA profession could be severely undercut by any reforms that restrict the services small audit firms perform for their clients.

There is much to do post-Enron to restore confidence in Corporate America and the accounting profession. As you have heard from my colleagues, the AICPA and its members, large and small, fully support many important reforms. As Congress considers these issues, however, I urge you to consider the unintended consequences of short-term legislative solutions in your effort to respond to the Enron business failure.

PREPARED STATEMENT OF OLIVIA F. KIRTLEY, CPA

FORMER CHAIRMAN, BOARD OF DIRECTORS, AICPA (1998–1999)
RETIRED VICE PRESIDENT AND CHIEF FINANCIAL OFFICER
VERMONT AMERICAN CORPORATION

MARCH 14, 2002

My name is Olivia Kirtley. I am a Board Member and Chair the Audit Committees for three publicly-traded companies, including ResCare, Inc. and Alderwoods Group, both Nasdaq companies, and Lancer Corporation, which is listed on the American Stock Exchange. I am also recently retired as the Chief Financial Officer of Vermont American Corporation in Louisville, Kentucky and past Chair of the Board of the AICPA. My remarks today will focus primarily on matters of corporate governance. However, I want to begin by discussing the importance of advice received from external auditors based on my experience as a CFO and an audit committee member.

There are a number of areas outside the scope of the financial statement audit in which a company's independent CPA is in the best position to offer advice, which presents no conflict to the auditor's role. This advice benefits the company and its shareholders rather than compromising the integrity of the audit. In addition, a ban on the use of services of this nature can significantly inhibit small and mid-size growth companies that may not have this expertise in house. Banning auditors from performing nonaudit services for their audit clients will also have a negative impact on the larger economy. Costs will rise when businesses are required to contract and train multiple providers of services most efficiently provided by one firm. Efficiency will suffer as current practices are altered to adhere to new mandates and companies are prohibited from contracting with providers of their choice. Business decisions will suffer from the loss of expertise now provided by the auditor's deep knowledge of the businesses they audit.

Executive Compensation

With a significant amount of many executives' personal wealth that are based on short-term financial targets, the potential exists for some to sacrifice a company's long-term health and well-being for short-term gains. We believe two items in this area are worthy of further consideration: (1) requiring the disgorgement of executive bonuses paid on the basis of grossly inaccurate financial statements, a concept for which the President has expressed support, and (2) encouraging the compensation committee of the board to review the incentives driving executive compensation for balance between short- and long-term financial and nonfinancial goals.

Audit Committees

Audit Committee Composition

We all know that the work of audit committees has become more difficult and demanding, and it certainly is under more public scrutiny. Moreover, the expanding complexity of issues that audit committees are called upon to address has caused the board to place greater reliance on the audit committee with respect to technical accounting, reporting and auditing oversight. In recent years, audit committees have been the subject of much study and attention; just 2 years ago, new rules were issued by the SEC and the stock exchanges addressing the independence and experience of audit committee members.

A primary focus has been the financial acumen of audit committee members. In this regard, the *Blue Ribbon Committee on the Effectiveness of Corporate Audit Committees* (Blue Ribbon Committee) recommended that corporate audit committee members be financially literate but only one member must have accounting or related financial sophistication or expertise. But what is "financial literacy"? Presently, the definition is nebulous, at best, with two different market regulators adopting different, yet vague, definitions that may not be sufficient to meet shareholders' increasing expectations.[1]

Although it is not currently required, we recommend that the listing authorities consider requiring the majority of audit committee members to have accounting or related financial sophistication or expertise, in order to minimize the reliance on one committee member. If a member lacks sufficient expertise, he or she may not understand the issues, know the questions to ask, or have a basis for considering the adequacy of the response provided. In light of the increasing complexity of the tasks, we also believe that consideration should be given to requiring at least one CPA with appropriate technical or industry expertise to serve on the audit committee and, if this is not possible, then audit committees should be encouraged to seek outside assistance or input on a regular basis from someone other than the auditor or management.

Audit committee work, like public accounting work, requires significant judgment. It is not an exact science. Accounting and financial sophistication or expertise will not guarantee that mistakes in judgment will never be made, but it certainly should mitigate the risks.

Communications with the Audit Committees

The Blue Ribbon Committee also cited a need for improved and more frequent communication between audit committees and the independent auditors that would cover such important areas as estimates and judgments, internal controls, significant risks, the clarity of the company's disclosures and the degree of aggressiveness or conservatism of the company's accounting principles. In addition, the Panel strongly supported more proactive audit committees and a stronger relationship between the board (and their audit committees) and the independent auditors. In response to these recommendations, new auditing standards and revisions to audit committee charters have created a framework for such enhanced communications to occur on a regular basis.

Another reform that would further strengthen the effectiveness of the audit committee, however, would be to require audit committees to hold separate executive sessions, on a periodic basis, with financial management, independent auditors, and internal auditors. The use of executive sessions as a fact-finding tool is indispensable, providing an environment where: (1) committee members are able to probe more deeply to assure they are fully informed regarding risks, issues, and judgments, and (2) participants are given the opportunity to confidentially voice concerns they might not otherwise express.

Quarterly Financial Reviews by Audit Committees

Current standards place significant emphasis on the annual audit, but what about the rest of the year? Generally, a quarterly review is required to be performed by the independent auditor, and the market regulators recently implemented a require-

[1] The Nasdaq's definition is as follows: "All directors must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. At least one director must have past employment experience in finance or accounting, requisite professional certifications in accounting, or other comparable experience or background, including a current or past position as a chief executive or financial officer or other senior officer with financial oversight responsibilities." The NYSE's definition is as follows: "The Board of Directors has determined that each audit committee member is financially literate, or will become so in a reasonable period of time, as such qualification is interpreted in the Board's business judgment."

ment that the review results be discussed with the audit committee, or at least the chair of the committee, prior to the release of earnings. Much like the haziness of the "financial literacy" requirement, however, these limited interim review requirements are not universally understood by Board members, audit committee members or investors.

Unlike the detailed work of an annual audit, a quarterly review primarily involves auditor inquiries of officers and others involved in the company's financial reporting function, a "high-level" review of significant transactions, and some analytical procedures. It is not an audit. One must ask if this is sufficient to meet the needs of investors in the fast-paced, ever-changing business environment in which companies operate, with numerous transactions and decisions occurring throughout each quarter. The requirements of quarterly reviews should be reviewed for sufficiency in meeting the need of investors for information on an ongoing basis.

Audit Committee Interaction with the Internal Audit Function

Increasing attention is being given by audit committees to the benefit and value that internal auditors can provide. Given the role internal audit departments play within a company, and their exposure to the many financial and nonfinancial areas in the company, we believe that internal auditors should have a direct reporting responsibility to the audit committee, and provide independent communications with the audit committee. If an internal audit function is in place, senior management should not be able to terminate the head of an internal audit department without audit committee approval.

Recent Audit Committee Rulemaking

It is critical to note that significant audit committee rules and regulations have taken effect over the last 2 years as the result of the Blue Ribbon Committee's recommendations. During that time period, the SEC and stock exchanges have implemented other measures including requiring formal audit committee charters and requiring audit committees to be composed of all members meeting the financial literacy requirements. These new requirements must be given time to work. In my experience, I have seen significant improvements in the effectiveness of audit committees since the new requirements have been implemented. Although we have outlined several suggestions for audit committee reform, we must resist the temptation to layer on too many additional rules for audit committees and the corporate governance process before allowing recent audit committee requirements to have an impact.

Thank you for the opportunity to appear before this Committee.

PREPARED STATEMENT OF JAMES S. GERSON, CPA

CHAIRMAN, AUDITING STANDARDS BOARD, AICPA

PARTNER, PRICEWATERHOUSECOOPERS, LLP

MARCH 14, 2002

My name is Jim Gerson, Chair of the AICPA's Auditing Standards Board. I am also a partner with PricewaterhouseCoopers. My objectives today are to briefly describe the auditing standards board, the role of the independent auditor and to highlight some significant changes in auditing standards that have just recently occurred, or will take effect shortly.

The Auditing Standards Board

The Auditing Standards Board is a senior committee of the AICPA authorized to set authoritative auditing standards commonly referred to as Generally Accepted Auditing Standards. Our committee is made up of 15 members, appointed to achieve an appropriate representation among CPA firms, as well as the public. At present two of the 15 seats are reserved for public members, currently filled by an academician and a Government auditor. We hold regular meetings that are open to the public and attended by the SEC, the POB, and other constituents.

Role of the Auditor

Let me focus briefly on the role of the independent auditor in the financial reporting process. The objective of a financial statement audit is to provide assurance as to the credibility of management's financial statements. An audit consists of a series of test procedures, such as examining inventories, confirming accounts receivable and obtaining an understanding of a company's system of internal controls. Such tests are designed to gather evidence to enable the auditor to express an opinion

as to whether a company's financial statements are presented fairly, in all material respects, in accordance with Generally Accepted Accounting Principles.

The auditor's conclusions are reflected in the auditor's report. The report may notify financial statement readers about material departures from GAAP, changes in accounting principles, or a variety of other matters. The intended goal of financial statements accompanied by an auditor's report is to provide information that is reliable and useful to investors, creditors, and other constituencies.

One question we are often asked is: "What is the auditor's responsibility to detect fraud?" Let me assure this Committee that, as auditors, we recognize our responsibility to plan and perform every audit to obtain reasonable assurance, within the limitations inherent in the nature of an audit, as to whether the financial statements are free of material misstatements, whether caused by fraud or unintentional errors. Even a properly designed and executed audit, however, cannot provide a 100 percent guarantee that a material fraud will be detected. We are working hard to continually improve both auditor performance and our fraud guidance.

Recent Initiatives

Let me briefly outline a few of our initiatives, many of which predate the issues surrounding Enron. First, we issued an exposure draft last month of a proposed standard entitled *Consideration of Fraud in a Financial Statement Audit.* This proposal supercedes prior guidance and will substantially enhance the ability of auditors to detect material misstatements arising from fraud. A major change in this new standard is the addition of required procedures that respond to the POB Panel's call for a forensic phase. Specifically, it responds to what they call a forensic phase by requiring, as part of *every* audit of an SEC registrant, even when fraud is not suspected:

- Discussions among engagement team members as to how and to where fraud could occur.
- A requirement to perform certain substantive audit procedures to test for the intentional override of internal controls by management.
- A continual evaluation of fraud risks throughout the audit, as well as at or near the end of the audit process.

I will very briefly outline some initiatives in other areas.

Last year, we formed a task force that is working to improve the auditor's risk assessment process. Through a more robust risk assessment process, auditors will be able to better understand where material errors are most likely to occur in the financial statements, and what auditing procedures are best suited to respond to those errors detected.

We have undertaken a project to create a new standard on auditing "fair value" that we intend to expose for comment this spring. We previously issued detailed standards on auditing derivatives and similar financial instruments. Additionally, we are in the process of updating and improving our related audit guide and will be adding a new chapter that will provide guidance on auditing energy and other commodity contracts.

In December 2001, in response to recent events and in time for this year's audits, we issued an auditor's "toolkit" to serve as a valuable reference guide when dealing with the complex topic of the potential abuse of related-party transactions. Through this toolkit, we are advising auditors to evaluate the possibility that related-party transactions may be motivated by a desire to improve reported earnings or by fraud.

In response to growing demands for more timely reporting, we have actively participated in developing continuous auditing or assurance methodologies. This concept involves reporting on shorter time frames and can relate to either reporting on the effectiveness of a system that produces data or reporting more frequently on the data itself. We believe that the technologies, if not the tools, required to provide continuous assurance services are, for the most part, currently available. Their actual implementation will evolve, as the concept of more frequent reporting gains additional support and appropriate, specialized software tools emerge.

Conclusion

Investors depend on auditors to communicate the reasonableness of the company's financial information and to provide confidence in the numbers. When an investor reviews a company's financial statements, an independent audit should provide the investor with confidence that the company is playing by the rules.

As a profession, we know that we can and must do a better job. I believe the entire auditing community would agree with me when I say that we are deeply concerned about recent events that have shaken the public's confidence in the financial reporting process. We are committed to continually improving auditing standards and the guidance we provide to auditors, so that investors and others who rely on

an auditor's report can place full confidence in the audit process and the members of the profession who perform this valuable service.

PREPARED STATEMENT OF ROBERT E. LITAN [1]

VICE PRESIDENT AND DIRECTOR, ECONOMIC STUDIES PROGRAM
THE BROOKINGS INSTITUTION

MARCH 14, 2002

Thank you, Mr. Chairman, for inviting me to appear today to discuss accounting and disclosure issues in the wake of the Enron failure.[2]

I come to you with a somewhat different background than many of those who have appeared before you so far—not as a professional accountant or securities regulator, but as an individual who has spent most of his career in a policy research setting and in Government working on a variety of issues, some of which have touched on Enron-related questions. In particular, much of my research has focused on the financial services industry, while in my years in Government, I have helped enforce the Nation's antitrust laws and overseen or worked with the budgets with a number of Federal agencies, including the SEC. Of perhaps greater relevance to the current hearing, I have co-authored a book with my colleague from AEI here today, Peter Wallison, on what we believe to be some of the cutting-edge issues in accounting and disclosure,[3] and am in the process of co-authoring another book on disclosure policy in a world of increasingly global capital markets. I hope through these various experiences and endeavors I can provide the Committee with some fresh insight into the challenges it and the entire Congress now confront.

Overview

The Enron failure poses some of the toughest policy challenges of any financial collapse in recent memory. The current situation is not comparable to the savings and loan or the banking disasters of the 1980's, which were nearly a decade in the making before Congress finally took action. By comparison, the disclosure problems that have surfaced in Enron have been apparent only over the past several years, especially the growing numbers of earnings restatements and the rising concern about "earnings management" expressed by the SEC and others. More importantly, whereas in the S&L and banking cases there were clear "solutions" on the "policy shelf," as it were, for Congress to implement (notably, the system of prompt corrective action for enforcing capital standards), only some ideas are on the shelf this time and there appears to be only a limited consensus on which ones ought to be adopted.[4]

This should not be alarming because improving the disclosure system is a complicated subject with few absolutely clear answers. As Paul Volcker pointed out in his testimony before this Committee on February 14, the growing complexities of business—reflected in a dizzying array of new financial instruments and corporate organizations—pose increasingly difficult challenges for any system of disclosure. The fact is that for many kinds of transactions, there are no single "right" answers,

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[2] The Enron failure raises numerous other public policy issues, including those relating to pensions (401(k) plans in particular), corporate governance, derivatives disclosures, which Congress, the Administration, and the regulatory agencies will be addressing this year and possibly beyond. I am confining my remarks here, however, to the issues itemized in the invitation letter from Chairman Sarbanes: "financial reporting by public companies, accounting standards, and oversight of the accounting profession."

[3] *The GAAP Gap: Corporate Disclosure in an Internet Age* (AEI-Brookings Joint Center for Regulatory Studies, 2000).

[4] Similarly, during the Depression, Congress and the Roosevelt Administration took some ideas that had long been on the policy shelf and adopted them into law, notably deposit insurance and the Glass-Steagall Act's separation of commercial and investment banking (although 2 years later, Senator Glass expressed regret about its passage).

which helps explain why the Financial Accounting Standards Board often takes so long before setting new standards or refining earlier ones (and why International Accounting Standards instead are framed in a more generic fashion, allowing accountants more discretion in deciding how to account for various transactions than is the case under Generally Accepted Accounting Principles in this country).

The same is true for improvements to the system for overseeing auditing, or what I would call the "enforcement problem." There is a compelling case for replacing or at least supplementing the current system of State supervision and self-regulation of auditors, as this Committee already has heard from previous witnesses. But there are arguments for and against each of the possible reform measures, as I will explain shortly.

Meanwhile, Congress should be mindful that markets and regulators have already engaged in a lot of "self-correction" in the wake of the Enron affair and of the facts that this Committee and others have helped to uncover and publicize. Based on popular press accounts and conversations with knowledgeable observers, my impression is that a number of companies (including America's largest in terms of market capitalization, General Electric) already have delivered more disclosure; corporate boards, and their audit committees in particular, are paying closer attention to accounting issues and the choice of auditors; accounting firms have tightened up on their audits; financial analysts and credit rating agencies, chastened by their past performance, have become more discriminating; and the SEC is apparently doing the best it can with its limited resources to scrutinize corporate financial statements for possible problems.

So what should Congress do at this point? This Committee and others are taking the right approach by first gathering facts and views from the experts. But you will inevitably find that at least so far there are many conflicting views. You should also be wary of all those who profess to know for certain about what reforms are most appropriate. The fact is that we—the Congress, the Administration, the experts, the investors, and the wider public—are all in the process of trying to figure out the best response. I am no exception in this regard: My own thinking continues to evolve as I gain more facts and learn of additional policy suggestions, and I ask you to bear that in mind as you hear the remainder of my testimony.

Accordingly, my best advice at least on the disclosure-related issues, is that if Congress enacts legislation (rather than leaving the reform job solely to the SEC), it do so in a broad fashion allowing for significant flexibility. It can do this with broad, general instructions to the SEC, but leave the details to the Commission. Flexibility is important in this area precisely because it is complex, the answers to current problems are not obvious and often contentious, and the problems themselves may appear differently several months from now or even next year, than they do now.

In the remainder of my testimony, I distinguish between issues relating to accounting standards, enforcement issues, one issue relating to the fate of the accounting industry post-Enron (possibly even greater concentration), and a set of cutting-edge disclosure issues that should be addressed at some point. Along the way I will briefly discuss certain of the Administration's proposals, as well as some of the reforms that I do not believe would solve any problems, or that conceivably might entail more costs than benefits.

Accounting Standards

The major immediate accounting problem exposed by Enron's failure was the weak consolidation rule prescribed for highly leveraged "special purpose entities" (SPE's). As this Committee and others in Congress have heard, Enron failed in part because of losses arising out of the many SPE's that it had created.

In brief, the rule for some time has been that sponsors of an SPE need not consolidate it so long as outside investors contribute a majority of its capital and that investment constitutes at least 3 percent of the SPE's assets. Putting aside the SPE's where Enron appears to have misled its auditor, Anderson, about the amount of outside investment (thus wrongfully avoiding consolidation), it is now clear that the 3 percent test was much too weak. FASB has since raised the 3 percent of assets threshold to 10 percent, clearly a move in the right direction.

The more difficult, larger issue relates to FASB's standard setting process itself, however. As the Committee has heard from other witnesses, FASB is slow to set standards (the incredibly quick revision to the SPE rule being a notable exception) and when it does, it is often subject to political interference.

Changing the funding of FASB from voluntary contributions from accounting firms and companies (the current practice) to some sort of mandatory assessment system, as some have suggested, would solve neither of these problems, although

it might diminish any perception that FASB must tailor its views to those of its funders (a charge I suspect that FASB would vigorously deny).

The slowness of FASB's standard setting could be addressed more directly by having the SEC impose deadlines on rule changes, with the threat that the SEC would take action by a date certain if FASB did not (as former SEC Chief Accountant, Lynn Turner, proposed before this Committee). I want to be clear: I am not enthusiastic about the SEC taking over the standards setting function altogether, which I fear could interfere with the other functions the Commissioners perform and could not guarantee any better outcomes. But I can see the value of having the *threat* of occasional SEC rulemaking as a way of keeping FASB's feet to the fire. The SEC could also become more proactive in reviewing, if not actually setting, FASB's rulemaking agenda on a regular basis, which could also help speed things up.

The downside of more active SEC involvement, however, is that it could result in even greater political interference in FASB's activities than already exists—most recently, with respect to FASB's efforts to set standards relating to the expensing of stock options and the accounting treatment of derivatives. There is a respectable view that politics is inherent in any rulemaking process, especially one that is supposed to be in the public interest, and so we should simply live with the fact. Moreover, it can be reasonably claimed that setting accounting standards is not a science and we should stop pretending that it is something so pure that it should not be affected by the views of the profession that applies them nor of the firms that have to abide by them.

At the same time, however, we should remember that the main purpose of accounting standards—at least for publicly-held companies—is to protect the interests of *investors,* not accountants and not the firms themselves. Accounting standards should help investors understand all relevant financial facts that will enable them, if they want, to make projections about future cash flows. Where the standards are changed or not implemented out of concern for affected firms rather than investors, who tend not to be organized and who in any event can always choose not to invest in the companies that may be lobbying the Congress or FASB on a particular rule, then the outcome may not be socially desirable.

In short, it is not that politics should be kept out of the rulemaking process—it probably never can be—but that the current system, at times, can too heavily favor narrow interests over the interests of investors as a class (of course, this a problem that is not unique to accounting standards). In theory, putting more investor or public representatives on FASB could help rectify the imbalance. In practice, however, if Congress wants the rules to benefit narrow interests, then there is little that even a more balanced FASB can do.

Similarly, moving the standards setting function to the SEC is not a panacea because Congress still exercises oversight of the SEC. The same would be true if FASB members were chosen directly by the Commission. As long as the SEC oversees FASB in some way and Congress oversees the SEC, I do not see how politics can be taken out of accounting standards setting.

In principle, the only option I believe would have a chance of at least making some difference is to move standard setting to an international body like the International Accounting Standards Board and thus accept international accounting standards (IAS), which the United States thus far has refused to do—largely out of the belief that U.S. GAAP is superior to IAS.[5] Of course, this is not the rationale for moving to international standards that is typically cited. Instead, the case for IAS rests largely on the view that a single set of accounting standards worldwide would eliminate discrepancies in accounting standards across countries, thereby facilitating cross-border movement of capital. In addition, removing sources of uncertainty generated by differences in national accounting conventions should reduce the cost of capital. In the wake of Enron, others also have argued that a system like the IAS that allows accountants more discretion is superior to the heavily rules-based system of U.S. GAAP which seemingly invites circumvention. (Precisely the opposite argument can be made, of course, *against* a system that allows more discretion, and thus potentially more freedom for managements to manage their earnings than already exists.)[6]

Whatever the merits of all of these arguments, the simple point I want to make here is that another potential, and possibly unrecognized, advantage of replacing

[5] The SEC allows foreign firms that want to list their shares here to use IAS, provided they also reconcile their financial statements to U.S. GAAP.

[6] A widely noted reason for the greater specificity of U.S. GAAP is that it is a response to the greater pressure of securities litigation in the United States than in other countries. If the United States adopted IAS, it is possible, if not likely, that our representatives would push the IASB to make IAS more specific over time for the same reason.

U.S. GAAP with IAS is that it would dilute the political power of American interests—whoever they are—to influence the outcome of the standard setting process. Take, for example, the fight over expensing stock options, which FASB was about to implement several years ago before it was stopped by a powerful lobbying campaign from the U.S. high-tech community. If standards were set solely by the IASB, our high-tech firms would make their views felt, but they could well run into significant opposition from standard setters from other countries. Indeed, it is just for this reason that moving away from U.S. GAAP to IAS, if it were ever seriously considered, almost certainly would arouse strong opposition in this country.[7]

Accordingly, I do not believe that replacing U.S. GAAP with IAS is a politically viable option, even if the IASB, under the strong leadership of Paul Volcker and David Tweedie, among others, convincingly updates IAS in a way that persuades many in this country that the international standards are superior to U.S. GAAP.[8] I hold this belief for another reason: Even if U.S. GAAP were replaced, it is possible, if not likely, that FASB or something like it would continue to exist in order to issue interpretive rulings of the broader principles-based international standards. If this were the case, and I suspect there would be strong pressure to ensure that it would be if U.S. GAAP ever were replaced by IAS, then FASB's interpretive rulings would gradually lead to a U.S. version of IAS, as well as the "international version." If other countries did the same thing, IAS could fragment over time back into multiple national standards.

It is possible, of course, that fragmentation would not occur—that national accounting bodies such as the FASB would simply fade away. Whichever view is right—fragmentation or monopoly—I lean toward a much different approach, one I would call "constrained competition" in standard setting. Under this approach—which appears to be gathering greater support within the academic community—U.S. law (or regulation) would give firms listing their shares on our stock exchanges a choice between using U.S. GAAP or IAS, without having to undergo the expense of reconciling the differences between the two standards, once some of the key differences between the standards are substantially narrowed. The remaining differences of lesser magnitude would continue to exist, and the two standards would simply compete, but the discrepancies would not be so large as to produce widely divergent results for most companies. In that way, investors would get the benefits of both greater harmonization (but not complete identity) of the two standards *and* the benefits of competition.

The benefits of competition in the standards setting arena are no different than in any other context. Like any monopoly, whether private or public, a single standard setting organization can stultify and be slow to adapt to market developments. Sound familiar? That is one of the main complaints about FASB. With competition, each standard setter would have a market-based incentive to keep up with the times and not drag its feet. Furthermore, if it really is true that any move to international standards would eventually break down into national versions of those standards (or at least a U.S. version), then some competition is inevitable. Why not simply recognize that to be the outcome, encourage the SEC and the FASB to set up a process for quickly narrowing some of the key differences between the standards—say, for example, with respect to revenue recognition, the handling of proforma statements, consolidation, and the expensing of stock options—and then let the competition begin?

Wouldn't there be a "race to the bottom" if competition in standard setting is allowed? The post-Enron experience suggests the opposite would occur. Ask GE, IBM, Tyco, or any number of other companies whose stock prices were pummeled by investors after the Enron affair became public. Investors (prompted to some degree by the business media) looked at the financial statements of these companies and apparently found their disclosures inadequate. The market encouraged each to become more forthcoming in its disclosures. Based on this most recent experience, I believe it is reasonably likely (although I admit not certain) that if firms had a choice in reporting standards the market eventually would punish the standard that analysts, academics, and financial commentators would view as the weaker one from an investor protection point of view. For the same reason, I also believe there is also a reasonable chance that competition in standards could weaken (although not entirely eliminate) political influence on standard setting. At the very least, constrained competition is worth a real try, there being no other obvious solution to the problem of undue political influence.

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[7] Those who fear a loss of "financial sovereignty" also presumably would weigh in against any move to a single world standard setter.

[8] Volcker is Chairman of the Trustees of the International Accounting Standards Board and Tweedie is the Chairman of the IASB itself.

Finally, what if after a reasonable period of competition one of the standards was driven out of the market, much as has happened in the markets for computer operating systems (for Intel-based personal computers) or video cassette tapes? If that is the result, then so be it. But given the international movement away from U.S. GAAP and toward IAS, it is likely that the loser in any competition would be U.S. GAAP, leaving IAS. But if national standard setters nonetheless continued to issue interpretations of IAS, then the market would not have moved to a single standard.

Enforcement

However much accounting standards may be perfected, investors will not be protected if the standards are not properly enforced by auditors. In light of the rising numbers of auditing problems in recent years, culminating with Andersen's widely publicized failures with respect to its audit of Enron, attention has properly been focused on how best to improve the verification of financial statements. There are two basic approaches, which are not mutually inconsistent, but ideally should be reinforcing: Improved monitoring or oversight of the auditors themselves and better (and more finely calibrated) incentives for those who conduct audits to carry them out properly.

Monitoring

I agree with others who have testified before this Committee who have criticized the current system of overseeing the auditing profession—a combination of self-regulation (and audit standard setting) by the AICPA and supervision at the State level. There is too much self-interest at the AICPA and its penalties are not credible, while State efforts lack resources and expertise.

As the Committee is well aware, the most discussed reform of the existing enforcement system is the creation of an independent body reporting to the SEC that would set and enforce auditing standards. SEC Chairman Harvey Pitt has outlined, and the Administration has basically endorsed, such a proposal for a new Public Regulatory Board (replacing the previous Public Oversight Board) that would have authority to set auditing standards and to investigate and punish wayward auditors (even while charges are pending). Most of the members of the PRB would be independent of the accounting industry, while the functions of the Board would be financed by assessments on accountants and the firms they audit. So far, to the extent the Pitt proposal has been criticized before this Committee and elsewhere, it is because it is said to not go far enough. A good case can be made that *all* of its members ought to be independent of accounting profession, and that its investigatory powers ought to be strengthened by at least giving it subpoena power.

If Congress is inclined to create a new monitoring authority like the PRB, then I agree with the SEC's critics on these points. But before Congress rushes to do this, I urge it at least to consider whether the SEC *itself* should be performing the oversight of auditors directly, although as I will argue shortly, it might make sense to establish a slimmed-down PRB to set auditing standards. Indeed, as I understand it, the Commission already has the requisite enforcement authority, but to the extent it doesn't, then Congress can easily give it what it requires. I cannot think of many examples in the Federal Government where enforcement authority like this is effectively contracted out to an independent authority. I used to work at the Justice Department, and we certainly did not contract out the entire enforcement job (although the Antitrust Division where I worked has engaged private counsel in specific, high-profile cases).

Why then create an independent auditing authority? Certainly, it cannot be credibly claimed that the job of overseeing auditors is more complex than overseeing the stock exchanges, investigating fraud or insider trading, or carrying out the rest of the Commission's statutory agenda. If nonetheless the reason for contracting out the supervision of auditors is that the SEC is short of staff and resources, as it clearly is, then there is an easy answer to that problem: Give it the necessary resources and finance it by an assessment—or what is more accurately a user fee—on any one of all of the following: Accounting firms, the firms they audit, or investors. Indeed, whether or not the SEC assumes the power of the PRB, it needs more resources, not just for more people but to raise salaries in order to stem its high rate of turnover, and if some kind of assessment is deemed necessary to finance the extra funding, then Congress should impose it.[9]

If the reason for creating an independent board is to shelter it from political interference, then that argument, too, shouldn't be decisive. The SEC has effectively contracted out the setting of accounting standards to the FASB, but that has not

[9] Last week, the Committee heard testimony about the inadequate resources at the SEC from the U.S. Comptroller General David Walker.

prevented affected interests from influencing what the FASB does. In fact, precisely because enforcement is an inherent Government function that is carried out elsewhere by other Federal agencies, Congress quite properly exercises its oversight responsibilities over those enforcement efforts. It would be no different if the SEC were to oversee the auditing profession directly.

The only plausible argument I have heard for creating the PRB is the claim that the enforcement of auditing standards requires an understanding of the intent behind the standards and so the two functions should be lodged in the same place. And since the thought of having the SEC write audit standards seems to many like a nonstarter, better to have both jobs carried out by an entity like the PRB under the SEC's oversight.

My response to this line of argument is two fold. First, many regulatory agencies write complex rules that they enforce, so in principle there is no reason why the SEC could not do both. If the SEC felt it did not have the requisite expertise to amend or rewrite the auditing standards that already exist—something that has not been demonstrated is necessary, by the way—it could look to an entity like the PRB to write the "first draft" and then formally amend or adopt the standards and any subsequent changes to them.[10] Second, even if the SEC delegates the writing of audit standards to a new PRB, it would still retain oversight over the organization. In this capacity, I do not see why the Commission and its staff, in carrying out their enforcement functions, could not be in regular contact with the members and staff of the PRB to clarify any possible misunderstanding over the meaning of particular audit standards.

So, at the end of the day, I favor lodging the investigation and the enforcement functions overseeing the auditing profession within the SEC, while leaving the preparation and refinement of audit standards to an organization like the PRB.

Better Incentives

Putting the equivalent of more and better "cops on the beat" is not the only way to improve auditing. Harnessing incentives is just as, if not more, important because it may be cheaper and more effective.

A number of incentives for auditors to perform their jobs already exist, of course. Auditors care about their reputations. And they certainly care about their liability exposure. Just ask the partners of Andersen who face potentially huge liability costs over and above the amounts that their insurer may cover. Or ask the partners of any other Big 5 accounting firm who must fear that the same thing could happen to them.

A problem with liability-based incentives, however, is that they can lead to overkill—to excessive caution as an understandable reaction to the threat of going out of business. Are there other more finely tuned incentives that might help?

The Administration has suggested that the CEO's repay any earnings-based bonuses if companies have to restate their earnings. This seems like an eminently sensible idea.

Another frequently mentioned proposal is to prohibit auditors from doing some or all types of nonaudit work for their audit clients.[11] Some have suggested going further and limiting auditing firms only to audit work for all their clients. The rationale for these various limitations, of course, is to remove any incentives that auditors may have to compromise their audits in the hope of holding onto lucrative nonaudit business. In fact, because this view is so widespread and out of a desire to preserve the reputations of their audits, all of the Big 5 firms, already have taken steps either to sell off some of their nonaudit businesses entirely (notably, information technology consulting) and/or not to perform nonaudit work for their audit clients. One question that you may want answered is whether these market-driven developments should be enshrined in some kind of legal prohibition on the nonaudit activities of auditing firms.

I am skeptical about the value of any permanent prohibition, but not because I agree with those in the accounting profession who in the past have argued that there are positive synergies to being in both the audit and nonaudit businesses. My skepticism instead is based on the fact that even if audit firms are limited only to

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[10] I do not believe there would be a significant danger of political interference in the setting of auditing standards, wherever that function is lodged, because of the highly technical nature of those standards and because it is difficult to predict in advance the impact on individual firms and industries of any generic audit standard. This is not the case with accounting standards (such as the expensing of stock options) whose effects are much more easily anticipated and quantified in advance.

[11] The Administration's proposed prohibition would apply where the nonaudit service "compromises the independence of the audit," presumably something the SEC would decide, presumably by generic rule.

audit work for clients, they still face the prospects of *losing their audit business,* which in a world of restrictions, would be the only business they have. As a result, audit firms could very well have the same incentives to compromise the quality of their work as they allegedly did before. (My skepticism does not extend, however, to a prohibition on an outside auditor doing internal audit functions for the same client, which also appears sensible.)

For the same reason, I am also somewhat skeptical of the value of another widely discussed proposal: The mandatory rotation of auditors every several years. It is possible, of course, that some auditors who know they are going to be replaced and have their work scrutinized closely by a successor, will be more careful in carrying out their work every year. Another effect may work in the opposite direction: Once the rotation is over, auditors may tacitly promise good treatment in the "beauty contests" that firms would hold on a regular basis in choosing their next auditor.[12]

In short, as long as management continues to choose the auditor, the potential will always exist for a conflict that could compromise the quality of the audit. One response to this is to intensify oversight of auditors for precisely this reason, as already discussed. The other response is to mandate that managers of publicly-held companies not be able to choose their auditors.

Who could do this instead? One obvious candidate is the audit committee, as several witnesses before this Committee have suggested. To maximize the committee's distance from management, it could be further required that all members of the audit committee on boards of directors be independent. Of all the options available, this is the best one, although I would caution it is not perfect (probably nothing is). Management can still exert a subtle influence—directly or indirectly—over even independent board members (who tend to be chosen or recommended by management, after all). In addition, for this option to really work, audit committee assignments probably would have to become far more time-consuming than attending quarterly board meetings. To this add the post-Enron fear of many directors of even serving on an audit committee, and it is all but certain that if the hiring of auditors is moved to audit committees, directors will not serve on them unless they are given much greater compensation than is now the case.

More radical alternatives would shift the hiring of auditors to third party entities—such as the stock exchanges, the SEC, or perhaps the PRB (if it is created), assuming that there is no appetite for having any of these organizations engage in the auditing itself (a massive undertaking that I clearly would not recommend). Having any one of these entities engage outside auditors would totally sever the link between the auditors and the firms they audit, and thus solve the conflicts problem. However, there are numerous practical problems associated with the assignment of auditors to the roughly 12,000 public companies that would require audits. In principle, the assignments could be made through bids or an auction, but a potentially very large bureaucracy would be required to administer that process. Also in principle, the cost and complexity could be reduced if the rights to audit numerous firms were lumped together. But in practice, how would the groupings be made, and on what basis? To what extent would firms found to have committed negligence in one or more cases be restricted from bidding for the rights to other audits? And then there is the problem of ensuring that no single auditing firm or a select grouping of firms smaller than the Big 5 effectively corners the market for audit services. This could be solved by imposing market share limits, but I fear such a step would also invite political interference into the auditor selection process (perhaps resulting in set-aside programs that might not be in shareholders' interests).

In short, because the practical difficulties of implementing any of the more radical measures appear too great, I believe an acceptable compromise is a rule requiring auditors to be hired by audit committees.

The Accounting Industry Post-Enron

One issue that has received relatively little public discussion in the wake of Enron's failure is what should be the attitude of public policymakers to the possible failure of the company's auditor. Clearly, this is a delicate matter, since Anderson is doing its best—at one time, with the apparent encouragement of the SEC—to settle the litigation against it. But what happens if the cases aren't settled, while audit clients continue to leave the firm?[13] It is certainly conceivable then that at some point the "Big 5" accounting firms reduce to the "Big 4," either through the migra-

[12] In addition, a mandatory rotation system would eliminate the market signal that comes about when a company now voluntarily changes its auditor.

[13] See, e.g., Kirstin Downey Grimsley, "Freddie Mac Drops Andersen; Delta May Follow Suit," *The Washington Post,* March 7, 2002 [noting that Andersen has so far lost three of its six largest audit clients].

tion of Anderson clients and/or partners to other firms or the outright failure of Anderson itself. Should policymakers be concerned about this possibility?

My very short answer is "yes" because an industry that is already highly concentrated—the accounting profession—would become more so. The thousands of publicly-held companies, not only here but worldwide, would have even less choice than they do now in auditors. With less competition, the result could well be higher prices and lower quality of auditing services.[14]

Since all this could happen without a merger, there is effectively no role for antitrust to play to ensure no diminution in competition. (Although Andersen now is reportedly in merger talks with one or more of the Big 5, any deal could easily be held up because of Andersen's liability exposure.) The only other way that competition would not diminish if Anderson failed or dwindled in size is if new entrants were attracted to the auditing business, existing second-tier accounting firms captured more audit clients, or the Big 5 (or Big 4, as the case may be) split up voluntarily (there being no way to force their split up absent any proof of an antitrust violation).

I do not know what public policy measures are or even should be available to encourage the split up of existing firms. Nor do I know what public policy, and perhaps specifically the SEC, could do to facilitate the entry of brand new firms to compete head to head with the Big 5 or the Big 4, or to somehow promote more use of the second-tier accounting firms right below the Big 5. At the very least, policymakers should signal their openness to entry and the use of second-tier firms (although the widespread concern about mixing audit with nonaudit functions will make it difficult for the Commission to encourage entry by firms in related fields, such as management consulting or financial services).

The only other way in which the policymakers might be able to make a real contribution is to remove any legal restrictions (regulatory, tax, or otherwise) that may now impede foreign accounting networks from gaining the requisite licenses and competing here in the United States. Accordingly, at a minimum, I would urge the Committee to make inquiry of the SEC to determine whether there are any such restrictions—formal or informal—that now exist, either or both at the Federal and State levels. If such impediments exist, I would then strongly encourage the Commission, and if necessary the Congress, to remove them—without waiting for any international agreement to gain reciprocal treatment from other countries (although that remains a worthy objective).

Beyond Enron

Finally, there are a range of issues relating to disclosure that have little to do with Enron, that may have received more attention had Enron not happened, and that should eventually get that attention once the preoccupation with fixing what apparently went wrong with Enron and other recent accounting affairs diminishes.

Peter Wallison is addressing in greater detail in his testimony one of these issues—the need for more and better *non*financial information about companies than is now routinely generated. Here I refer to measures of consumer or worker satisfaction, product or service quality, successful innovation, education and experience of the workforce and management, and a variety of other nonfinancial indicators. Individually or collectively, these nonfinancial measures may shed far more light for investors on the future ability of firms to generate earnings or cash flow, and thus on the long-run fundamental value of their stock, than the figures in financial statements that are based on historical costs that are inherently backward looking. In the *GAAP Gap* we urge the SEC to use its powers of persuasion in this area, perhaps by beginning to convene working groups of experts from different industries, to encourage firms to make more of these disclosures, and to do so consistently and repeatedly.

A second cutting-edge issue is how best to harness the power of technology—computers and the Internet—to facilitate more complete and more rapid corporate disclosure. One large-scale and potentially revolutionary private sector initiative that already is under way is a collaboration by a growing number of companies, accounting firms and the AICPA to develop a common "tagging" system for various financial accounts, which goes under the acronym "XBRL." Once these tags are fully developed and implemented by companies, a wide range of users—not just sophisticated users like financial analysts—will be able easily to take very detailed data from

[14] The Big 5 not only dominate the U.S. auditing market, but also as of 1999, accounted for 77 percent of the revenues of the 40 largest international accounting networks. Furthermore, as of the same year, the Big 5 audited 98 of the top 100 companies in the world, measured by market capitalization. See Lawrence J. White, *Reducing the Barriers to International Trade in Accounting Services* [AEI Studies on Services Trade Negotiations, 2002], p. 14.

companies and reconfigure it in multiple ways, using widely available spreadsheet programs.[15] Here, too, I would urge the SEC (and if necessary, urge the Committee to urge the SEC) to encourage this project and do what it can to publicize its importance and encourage companies to participate in the process of developing tags for information that may be industry-specific. The Commission may also want to consider ways in which it could encourage companies to use the tags at the earliest possible date. One possibility: Require EDGAR submissions to be in XBRL by a specific date.

A related project is for the SEC to encourage more frequent reporting. Chairman Pitt's proposal (which the Administration has endorsed) to increase the number of "significant events" that must be disclosed as they unfold—in as early as 48 hours after they occur—is a move in the right direction.[16] So is the Administration's proposal to require disclosure within 2 days when corporate officials sell their company stock.

But policy should not stop there. With the Internet, many companies now or may soon have the ability to make available to the public their financial reports much more frequently than on a quarterly basis—weekly, if not daily. Indeed, financial institutions already typically balance their books every night. Why not then consider ways to have this financial information communicated in the same time frame?

There will be objections to encouraging companies to make available unaudited financial information more quickly, but I believe these objections can be met. As it is now, quarterly financial data are unaudited and will remain that way unless the SEC or a new PRB come up with guidelines for more limited audits for more frequently reported data (in which case, liability thresholds would have to be adjusted to reflect any differences between the kinds of audits).[17] In any event, the capital markets would become much more volatile if investors came to believe that all unaudited financial information were useless. Even in the wake of Enron, I believe that the financial data produced by the overwhelming preponderance of public companies still have use, and I further believe that market participants hold that view as well (if not, stock prices would be well below where they are now). Accordingly, if in an age of computers and the Internet companies have the ability to publish their financial statements more frequently than every quarter, why shouldn't public policy encourage that result?

Actually, there is an even more compelling case for more frequent financial disclosures. This Committee has heard complaints from many witnesses previously about the seemingly uncontrollable trend toward earnings management—or the manipulation of quarterly earnings reports to achieve or exceed market expectations. To his credit, former SEC Chairman Arthur Levitt was one of the first to sound the alarm about this practice, which is evidenced by the significant increase in earnings restatements over the past few years. The problem is that in reading through numerous descriptions of the problem, I have yet to see an effective solution for it.

If, however, companies routinely reported their financial results much more frequently than every quarter, it is conceivable that investors and analysts would lose interest in the quarterly figures. Furthermore, it is highly doubtful that analysts would take the trouble to develop earnings forecasts more frequently than on a quarterly basis. Thus, there is a real chance that more frequent reporting could end incentives of managers—and their auditors—to engage in earnings management.

At the same time, I would be the first to agree that *mandating* more frequent reporting at this point is premature. Many firms simply may not be able to comply with such a requirement, even over a period as long as a month. Or the cost of compliance may be prohibitive. The challenge is to find a way to provide incentives to the firms that *are* able to report more frequently than quarterly to do so. Here, too, the Committee could play a constructive role by asking the SEC to review the options, and at the very least, lead a visible campaign to encourage more rapid reporting more suitable to the Internet age.

Finally, this Committee has commendably begun the process of exploring ways to improve financial literacy among the American public. Enron's failure has high-

[15] This is currently not possible because although company annual reports and financial reports filed with the SEC are available online, they are in a format (HTML) that cannot be manipulated by users, but simply read and copied as a text file. The major aim of the XBRL project is to enable users to accomplish these manipulations themselves (by using a related language, XML) and also to locate companies and information through computer-based search engines.

[16] Such additional events include the departure of top executives and the loss or gain of an important customer or contract. Under existing rules, companies must file "8–K" reports on key intra-quarter developments within 5 to 15 days.

[17] The Administration's proposal to require CEO certification of quarterly reports in addition to the annual reports may help, depending on the penalties and standard for invoking them. But the quarterly results still will be unaudited.

lighted in the most dramatic way possible the need for diversification—especially in pension plans—which is one of the most basic financial lessons all Americans should know, as early as possible in life. In the same vein, I applaud the Administration's proposal to require companies to write their quarterly financial reports in "plain English," which should improve information flow to those investors who invest in stocks directly (rather than through mutual funds). At the same time, however, I would caution that no amount of rule-writing or editing by the SEC relating to these plain English statements is likely to prevent the future Enrons that are intent on deceiving investors. Accomplishing that goal will require the implementation of the kinds of other measures I reviewed earlier in this testimony.

PREPARED STATEMENT OF PETER J. WALLISON [1]

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Mr. Chairman and Members of the Committee: I very much appreciate the invitation to appear before you today to talk about the important accounting issues confronting this Committee—as well as investors, companies, accounting firms, and the Securities and Exchange Commission—in the wake of the collapse of Enron Corporation. Robert Litan has covered very comprehensively in his formal statement the various issues that are now the focus of public attention, and in general I can associate myself with the views he expressed.

My testimony today, however, will look to the future, in large part because I believe that much of the current debate about the adequacy of Generally Accepted Accounting Principles—and whether they were properly applied or disregarded in the Enron case—may be beside the point. The fact is that GAAP accounting is becoming increasingly irrelevant for financial disclosure, and we must begin working on supplements and alternatives. I will attempt to explain why this is so, and discuss some of the ideas that seem necessary if we are to bring financial disclosure into alignment with where our economy is today. The accounting industry has foreseen this development, and has been working for years on how to address it. Much of what the industry has done, and much of what I will say today, is covered in a monograph, *The GAAP Gap: Corporate Disclosure in the Age of the Internet,* of which Bob Litan and I are the co-authors, published in 2000 by the AEI-Brookings Joint Center for Regulatory Studies.

If there is any good that can be said to have come out of the Enron collapse it may be the sudden attention now being paid to the adequacy of GAAP accounting, and the possibility it creates that a better system of financial disclosure will emerge from this review. But if this is to happen, it is necessary that this Committee, policymakers generally, companies and investors, and especially the SEC, understand that in tinkering with GAAP they are in a real sense fighting the last war. Just as we are now realigning our military force structure to deal with terrorism instead of an attack by the Soviet Union in central Europe, there is a need to get started on the process of revising our financial disclosure system to deal with major changes in our economy.

We are all very proud—and deservedly so—of the quality of our capital markets. The ease with which companies can obtain capital financing is one of the reasons we have the most powerful and successful economy in the world, and why ambitious and skilled people from all over the world want to come here to take advantage of the opportunities our economy offers.

The Importance of Information

But it is clear that our capital markets would not function nearly as well if investors did not have the information they need. Without information, investors are simply guessing, and when they do that they demand higher premiums or rewards to cover the additional risk they incur. This makes capital more expensive, and poor information reduces the efficiency with which capital is allocated among competing uses. Good information, on the other hand, reduces the uncertainty associated with making investments, and thus reduces one element of investment risk. Reduced investment risk in turn reduces the cost of capital. Lower capital costs generally

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means that more capital will be available for companies that need it, that capital will be allocated more efficiently, that we will have faster and broader-based economic growth, and that the welfare of all Americans will be enhanced.

But despite the importance of the information, and the legal structure we have erected in the United States to assure its disclosure, recent changes in the economy have made it difficult for investors to get the information they need for evaluating companies. This is not because companies are withholding anything they are otherwise required to disclose, or that existing laws and regulations are not being vigorously enforced. It is because the nature of the assets on which most public companies now rely to generate cash flows and profits have changed so radically in the last quarter century that we literally do not have the skills or means to describe their value.

Intangible Assets

According to some estimates, about 80 percent of the value of companies listed in the S&P 500 is attributable to their *intangible assets.* This represents an important change in how our economic system creates value, but it requires a momentous change in how we account for, report on, and disclose the financial significance of that value.

What are intangible assets, how do they differ from tangible assets, and what is the significance for financial disclosure of their coming to dominate the assets of American companies?

We have all heard of the so-called "post-Industrial economy," the "information economy" and the "knowledge economy." These by now clichéd terms refer to something real and undeniable—that the U.S. economy has moved from an industrial or manufacturing economy to one that creates value through services and the productive use of knowledge and information. Computer software and pharmaceuticals are two examples of products that are in one sense manufactured but in a more important sense are the products of human knowledge and skill rather than machinery or equipment. In other words, the value of these products is the knowledge and skill that went into creating them, not the few cents worth of plastic in each disk or the insignificant cost of the chemicals in each pill.

The assets used to produce these disks and pills are classic intangible assets—they exist only as ideas and concepts in the brains of the scientists and technologists who conceived and developed them. They cannot be touched, and in many cases they cannot even be sold. Stranger still, because they consist of the skills, knowledge, education, and imagination of a company's employees, they are not even owned by the companies which receive the cash flows from the sale of the goods or services these knowledge assets have produced. For this reason, the assets that are responsible for the cash flows of many—perhaps most—U.S. public companies do not and cannot appear on their balance sheets.

In addition, the productive assets of many companies include patents, trade secrets, formulas, computer programs, and other items that embody ideas or knowledge—and belong to the company—but were internally generated within the company and have values in terms of their revenue generation potential that far exceed their development costs. One of the unique characteristics of the knowledge economy is that companies develop their productive assets themselves, internally, rather than purchasing these assets the way industrial companies purchase machinery and equipment. Because there is no purchase involved, the cost as well as the value of internally developed knowledge assets is inherently uncertain.

We can also go one step further: Most companies depend for their success on their reputation—the views that their customers and suppliers hold concerning the quality of their products or services and the honesty of their dealings. In other words, whether such a company is able to generate revenues may depend on the views of others about it and not on anything we can actually see or touch. Obviously, the views of others are not recorded on a company's balance sheet.

eBay, the online auction system, is a good example of a knowledge economy company. It has a market value of about $14 billion and a book value of $1.4 billion. What is the driver of eBay's value? It has no inventory, warehouses or sales force. The only thing it has is the reputation it has built among the public, linked to a sophisticated and specially designed computer software system—neither of which can be valued fully by referring to their cost. That is why eBay's market value is so much larger than its balance sheet net worth.

Even Enron can be analyzed in these terms. For all the financial and accounting chicanery that may have occurred in the Enron case, the company's collapse to virtually nothing was the result of a massive loss of confidence in the honesty of its management. As a trading company, the company relied on reputational assets to

remain in business, and when this asset was dissipated there was virtually nothing of value left.

Since both eBay today, and Enron when it functioned, consisted of little more than a collection of intangible assets, the question a prospective investor might ask about both of them is how one might be able to tell, at any point in time, whether its intangible assets are increasing or decreasing in value?

Now, we are getting close to the issue. If you were an investor, and were considering the purchase or sale of a company's shares, you would want to know not just what the company had done in the past but what it was likely to do in the future. In fact, since your investment is all about the future, you would want to know as much as possible about what was producing the earnings or cash flows that are recorded in its financial statements, and whether those assets are likely to continue to produce those cash flows.

The Effect of Intangible Assets on Balance Sheet Values

To find this information, you certainly wouldn't look at the balance sheets of companies like eBay, because few of the assets that are generating its cash flows—the knowledge embedded in the software it uses, or the degree to which its services are valued by its customers, for two examples—are on its balance sheet. These intangible assets—the real source of its earnings and cash flows—are not captured by GAAP accounting, or for that matter by the International Accounting Standards that some regard as an alternative to GAAP. In Enron's case, the question would have been—as it is with all trading firms—whether they were building confidence and reputation in the market or depleting it.

In other words, in an economy where the principal assets that generate revenues and cash flows for companies are intangible assets, GAAP financial statements are useless to provide the information that investors really need—information about the quality or value of the assets that will produce these revenues and cash flows in the future.

It is important to understand that this is something new. When a company decides to build automobiles, it purchases the land, the factory and the equipment. These have a cost that can be readily ascertained and recorded on financial statements. This meant that the cost of the assets on a company's balance sheet were a reasonably good reflection of the company's actual value—since one could simply reproduce the same company by purchasing the same inputs. In theory, a company could be liquidated for the book value reflected on its balance sheet.

That is not true of companies that rely on knowledge. One cannot simply reproduce Microsoft or Merck by buying their offices, research labs, and other facilities. They are collections of employees—biological scientists, computer specialists, and chemists—whose knowledge and skill create the values of these companies. And although research and development costs might appear on a corporate balance sheet, those costs do not include the actual value of the education, imagination or resourcefulness of their employees and management—all of which continue to belong to these individual employees.

So when some sources estimate that 80 percent of the assets of the S&P 500 are intangible assets that is a fairly significant statement. It means that perhaps 80 percent of the assets that produce the cash flows and earnings of these companies will not appear—indeed can never appear—on their balance sheets.

The reason for this is that conventional (GAAP) accounting establishes value with reference to costs; it has no effective means for recording the value of the intangible assets internally generated by companies. To be sure, these have a cost of some kind—salaries, laboratory equipment and the like—but these costs do not capture the real value of the assets that are being put to work. Before the advent of the knowledge economy, when goods rolled off factory assembly lines, it was possible to get a good sense of an industrial company's value by looking at its balance sheet. One would know, within certain limitations, that if the company ultimately became bankrupt because of mismanagement its assets still had value, since they could still be used to produce goods and could be sold to someone who would use them more effectively. Indeed, until the 1970's, the market values of companies did not depart significantly from their balance sheet values. But as the knowledge economy developed, the ratio of market value to book value of public companies began to grow, so that in 2000 it had reached 6 to 1. Obviously, investors were valuing something other than what appears on balance sheets, and it seems reasonably clear that they were placing a value on intangible assets of these companies, even though these did not for the most part appear on their balance sheets.

The Effect of Intangible Assets on Income Statements and Price/Earnings Ratios

Now it might be objected that balance sheet values do not really matter anyway—that in the knowledge economy what investors are looking at is earnings, and the price/earnings (P/E) ratios of public companies are what is important. Let's leave aside for the moment the question of how an investor can have confidence that a company will earn in the future what it has earned in the past—something that comes from an assets of its productive assets and of course cannot be determined from an income statement. Instead, let's focus on what the GAAP income statement reports. Why is that statement not sufficient to give investors the information they need about companies in the knowledge economy?

The answer is that, once again, the inability to value intangible assets internally generated by companies creates distortions in income statements, making price/earnings ratios and other similar comparisons also unreliable.

A very good example of this problem is furnished by AOL's settlement several years ago of an SEC charge that, in capitalizing its customer acquisition costs during the years 1994 through 1996, it adopted a misleading accounting treatment. Many of us saw evidence of the enormous amount AOL was spending on customer acquisition in those years, because we received unsolicited disks in the mail with which we could sign on to AOL and try its services. When a company capitalizes a cost like this, it means that it is treating the cost as though it were an investment rather than an expense. In GAAP accounting, of course, cash spent on an investment has no impact on earnings except through depreciation over a subsequent period of years. In capitalizing its customer acquisition costs, AOL claimed in effect that these costs were producing an intangible asset—customers who would use its services in the future—and that the proper accounting treatment would be to capitalize them when they occurred, and to amortize or depreciate them against the earnings from these customers in future years.

The SEC disagreed. It argued that by capitalizing these very large costs AOL showed earnings in 1994 through 1996, when—if it had written off these costs as incurred—it would have shown losses for those years. In 1997, under pressure from the SEC, AOL changed its accounting treatment, so that it expensed its customer acquisition costs.

Was this the right treatment? The answer—*in light of later developments*—is clearly no. AOL, as we all know, turned out to be a great success, largely because it accumulated a huge number of customers before anyone else. This is a network phenomenon, now well-known, in which each additional customer adds value to those already on the network and the network itself becomes more valuable as it acquires new subscribers. In other words, AOL's customer acquisition costs really *were* investments, since they produced a very large, profitable, and ultimately market-dominating customer base. But because these costs were—at the SEC's insistence—written off (expensed) as they were incurred, AOL's current earnings were in effect understated for the years in which this accounting treatment was required.

Let's stop for a moment and consider what effect this had on the price/earnings ratio for AOL's shares. Before the write-down required by the SEC, let's say AOL had a P/E of 50—very high by historical standards. After the restatement of its earnings—because it now showed losses in each of the 3 years—it had a P/E for those years that was essentially infinite. Market commentators and analysts who looked at AOL's GAAP earnings (or lack thereof) would conclude that it was vastly overvalued based on this enormous P/E.

But as it turned out, AOL's original treatment was correct. It *was* making an investment when it spent so much to gain customers. We can see that now. But if an investor at the time recognized the value of what AOL was doing, he or she might have been willing to pay quite a lot for the company even though it was showing losses. In other words that perceptive investor would have realized that AOL was creating an intangible asset that had considerable value because it would generate enormous profits in the future. In fact, the cost of building this asset, because it was reducing current earnings, actually made the company look worse, probably lowering the market price at which our savvy investor could acquire shares.

This example shows that in a knowledge economy seemingly sophisticated commentary about companies or a whole market being "overvalued" because price/earnings ratios are high by historic standards can be quite misplaced. Investors, as in the case of AOL, may be placing values on internally generated intangible assets the costs of which are being written off as incurred under prevailing GAAP accounting. This treatment both reduces earnings—thus increasing P/E's—and hides from investors with less sophistication the development of an asset that will be responsible for large cash flows in the future.

It is important to mention here that there is no cure for this problem in GAAP accounting. If AOL had turned out to be a failure, the accounting treatment de-

manded by the SEC might have been seen as the right one. The asset that AOL thought it was building was not worth the cost. The losses from 1994 through 1996 were real losses, and to the extent that investors were warned off the company by these losses they would have been saved some losses of their own.

How can investors tell the difference? They probably cannot in any precise way. They may be guessing, but overall—given the wide divergence between market values and book values, and the historically high P/E ratios in today's markets—they are seeing something in companies that conventional accounting is not recording.

This situation is not the result of a deficiency in the skills or imagination of the accounting profession. There is simply no reliable way to place a value on internally generated intangible assets—to measure the value of the asset AOL was building through its customer acquisition costs. There is no market for most intangibles, especially those that are unique to the company that created them, so there is no known way to establish their value for balance sheet purposes.

This is not a healthy situation. If financial statements do not allow investors to understand the real value of a company, if investors are left to guess, they are taking risks. Risk, as I noted above, raises the cost of capital, promotes volatility, and ultimately distorts the allocation of capital.

In other words, the almost 60 year effort to create a more efficient market—in large part by making sure that investors have the information they need—has been at least partially defeated by the advent of changes in our economy. These changes have made intangible assets the real drivers of company value, but this has happened before we have had an opportunity to develop the means to assess and to communicate what these assets are actually worth. The result is an increasing discrepancy between what financial statements are telling us and what the market sees—and hence more uncertainty, more volatility, higher than necessary capital costs, and less efficiency in the allocation of capital in our economy.

Data Elements and Real Time Financial Reporting

There are also other inherent problems with financial statements that are worth noting. For one thing, they are inherently backward-looking. They tell us what happened to the company over the last quarter, or the last year, but not much about what will happen in the future. In fact, under some circumstances financial statements can be actively misleading about the future.

Take the case of Xerox Corporation. While Xerox was exploiting its patent—from the mid-1950's through roughly the mid-1970's—it was a very profitable company. Unfortunately, however, the copiers that the company was producing, while in high demand because of their unique features, were highly unreliable and frequently needed repair. The company found that by selling the copiers instead of renting them it could make even more money—first on the sale, and then by charging for repair services. So until its patent expired, Xerox showed increasing earnings.

However, as soon as competitors were able to use its technology, Xerox was nearly driven out of business. The poor quality of its copiers had infuriated customers, and as soon as they had a choice they changed brands. In other words, even though its financial statements were showing healthy and profitable growth, the company was hollowing out. Investors who relied on Xerox's financial statements, and did not know the degree of its customer dissatisfaction, were in for a shock.

Here again, we encounter an intangible asset—customer satisfaction—that does not appear on a balance sheet and yet can be more important for predicting the future than what does. In other words, financial statements, because they are backward-looking, are inherently deficient in the information that investors want most to know about—the company's future. What is needed is information that supplements the financial statements—that provides some indication of the company's prospects.

Finally, financial statements suffer from one other inherent deficiency. They are issued periodically—quarterly or annually. Between these reports, the market is full of speculation about what they will contain. This speculation adds to uncertainty and volatility, and therefore to risk. The way financial statements are prepared—involving decisions by management and the aggregation of many different items into a relatively few lines—this delay is probably unavoidable. But that should not necessarily mean that all data on a company's operations has to be issued at periodic intervals.

In the past, when it took a while to assemble financial and other data, periodic releases were unavoidable. Today, however, when a good deal of information is available to management in real time, there is a question whether some of it could not be released more quickly. In fact, the delayed release of financial data may be leading to earnings management—where companies coach analysts to reach conclusions concerning the company's earnings, and then companies come forth with earn-

ings that slightly beat these estimates. If this is happening, it further suggests that investors' lack of confidence in financial statements is well founded.

The accounting profession has been developing ways for companies to make financial disclosures on a more timely basis—in some cases virtually in real time—and this subject is covered in *The GAAP Gap* and in the formal testimony of my colleague Bob Litan.

Possible Solutions and the Obstacles They Face

It seems clear then that our economy—as it comes to rely increasingly on intangible assets as the source of company values—must have some way to assess the quality of these assets. We must recognize that GAAP accounting can never do this, and may in fact distort perceptions of value.

The inherent deficiencies in financial statements have drawn the attention of the accounting profession. As early as 1991, the Financial Accounting Standards Board (FASB) issued a report—now known as the Jenkins Report—concluding that the information furnished by companies should be forward-looking and user-driven.[2] As the problems associated with intangible assets became more pronounced, accounting firms themselves began developing ideas for ways in which companies might communicate the value of their intangible assets and how they were meeting their goals.[3]

On an official level, the Organization for Economic Cooperation and Development (OECD), which is a program supported by many of the major industrialized nations, has begun an intensive effort to find and to develop nonfinancial indicators or measures that would permit investors to assess the prospects of companies or the value of their intangible assets. The indicators are nonfinancial in the sense that they involve information that does not appear in financial statements.[4]

To take the AOL and Xerox examples, the hope would be that nonfinancial indicators or measures could be developed that would have allowed investors and analysts to get a better picture of whether AOL's customer acquisition costs were likely to pay off in the future, or that Xerox was incurring customer enmity rather than fostering customer satisfaction. In both cases, a great deal of uncertainty would have been eliminated, investors would have a better sense of how to value the intangible assets of both companies, and the securities markets would have functioned more efficiently.

Thus, many groups see the need for making useful nonfinancial information available to investors. But up to now progress has been slow.

First, there is really no comprehensive theoretical framework for the development of this information. There hasn't been any significant testing of the efficacy of various indicators, there are no universal indicators that could be applied to all businesses, and there are very few for specific industries or activities. In research for *The GAAP Gap,* I came across a few suggestions for indicators, and I have attached a list to this testimony, but as far as I know none of these indicators is now being used by a U.S. public company as part of its regular disclosures to investors.

Second, there is concern among companies in proceeding down this road. Companies say that they are concerned that the information they will have to disclose will be helpful to their competitors, or that disclosures will result in legal liability. There is some merit in these concerns, but they may be somewhat exaggerated.

Third, many companies see no value to them in taking the trouble to develop indicators, or the information that the indicators would require them to disclose.

On the other hand, there are several areas where businesses are already cooperating in activities that are closely related to the development of indicators that would be useful for investors.

First, many industries participate in a process called "benchmarking," in which they seek to develop the best practices by exchanging information about the way they conduct certain kinds of operations, such as employee recruitment and training. Testing whether these practices are effective involves statistical comparison of indicators.

Second, a number of industries are currently developing supply chain standardization, so that they can save procurement costs by creating accepted definitions for commonly used parts and services. This would enable a manufacturer, for example, to solicit bids for a particular part from a worldwide group of potential suppliers—

[2] American Institute of Certified Public Accountants, *Improved Business Reporting—A Customer Focus, http://www.aicpa.org/members/div/accstd/ibr/appiv.htm,* February 21, 2000.

[3] See, e.g., PricewaterhouseCoopers, ValueReporting Forecast 2000, 1999.

[4] Organization for Economic Cooperation and Development, "Public-Private Forum on Value Creation in the Knowledge Economy—Overview," 2000, *http://www.oecd.org/daf/corporateaffairs/disclosure/intangibles.htm.*

all of whom would understand the specifications the manufacturer desires without having to meet and discuss them. The definitional problems associated with this activity is not far removed from what would be required to develop common measures or indicators.

Finally, for a number of years businesses have been developing, for internal use, indicators that tell management whether and how well a company is achieving its goals. These indicators are not shared outside the company, but they could be. In fact, a few companies do make some of their internal indicators public. Skandia International Insurance Company, a large Swedish insurer with a worldwide financial services business, has for almost 10 years been making public, in time series, the indicators it uses to measure the success of some of its subsidiaries.

To be sure, even if these internal indicators were made public they would still not permit the comparisons across competing companies that would be most useful to investors. Before this might be possible, certain indicators would have to gain industrywide acceptance. Nevertheless, making public the results of company-specific indicators, in time series, would be a good start. It is important to remember that Generally Accepted Accounting Principles—on which we rely today to make comparisons among companies—hardly existed as late as the 1950's. Financial accounting is hundreds of years old, and for most of that time individual firms, and then whole industries, had unique ways of accounting and reporting their results. Although we do not have hundreds of years—or even half a century—to develop the indicators that are necessary to supplement financial statements, a good place to start might be with companies making public the indicators they use themselves.

Finally, and perhaps most important, there is data indicating that increased disclosure can have the effect of lowering capital costs.[5] This stands to reason—since more information reduces uncertainty and hence volatility and risk. If this can be demonstrated to the satisfaction of companies—either through analytical work or by observing experience of others—a virtuous circle could result, in which successful companies disclose extensive amounts of nonfinancial information in order to achieve lower capital costs, and others must follow suit in order to remain competitive.[6] A lot of value could accrue to the first mover.

Thus far, I have discussed indicators that are *derived* or interpreted from operating or other data of public companies. But there is also a class of information that might be called *data elements.* These are raw financial or nonfinancial facts that generally do not require any interpretation or compilation. As I suggested above, the number of patent citations would not be an example of such an indicator, since it requires the distillation of information from a number of sources. On the other hand, a data element might be a company's daily sales. This is the basic information a company uses to prepare its financial statements. Data elements can also be nonfinancial information, such as the number of employees—assuming that the term "employees" is suitably and precisely defined.

This data can also be disclosed, some or all of it in real time. The development of the Internet makes instantaneous communication, at virtually no communication cost, entirely feasible. In part, this would address the problem of periodicity in financial statements. If the market were to have access to significant information in real time it would put to rest a lot of speculation between quarters.

But developments involving the Internet enable us to go a step further with this kind of quantitative raw data. A new Internet language known as eXtensible Markup Language, or XML, is now coming into common use. Up to now, information on the Internet has been stated in a language known as Hyper Text Markup Language, or HTML. HTML is basically a set of instructions to a display mechanism—a monitor or a printer—on how to display the document as a whole. It does not generally permit individual items of data to be identified and extracted from a document. XML, on the other hand, permits the tagging of individual items of data with definitions and context, so that they can be extracted from the document in which they are imbedded. The word "bank" in a document, for example, would be tagged with a definition that would distinguish its meaning as a financial institution from its meaning as the side of a river, allowing documents on the Internet to be word-searched and data to be extracted for other uses. The accounting profession has begun to develop an accounting application of XML, known as XBRL. The details

[5] Botosan, Christine A., "Disclosure Level and the Cost of Capital," *Accounting Review* 72(3) (July 1997): 323.

[6] In working on *The GAAP Gap* in 2000, I was unable to find any firm that was actively in the business of developing indicators that would help clients ascertain the value of their intangible assets and eventually disclose this information as a supplement to their regular financial reports. Since then, I have come across Booth Morgan Consulting, LLC, with offices in Virginia and Connecticut, which does this for financial services firms.

of this innovation are covered extensively in *The GAAP Gap* and in Bob Litan's formal testimony today.

Clearly, the disclosure of data elements in real time is far different from the use of indicators. For one thing, companies would simply be disclosing factual information. Assuming it is accurate, there should be little if any legal liability associated with disclosures of this kind. Moreover, it is far less costly to develop this information than to develop the information used in indicators, since by and large it is information that 20 companies maintain anyway—either to prepare their financial statements or for other business purposes.

There is still the issue of providing useful information to competitors, but the question would be whether any of this data would provide as much useful information to competitors as the many things companies have to do "in the clear"—such as building plants, making acquisitions, or hiring skilled personnel. In any event, whether information will be of use to competitors is a matter to be worked out in considering specific information, not a reason to reject the whole idea out of hand.

The Role of Policymakers

The issue for policymakers is how to stimulate the development of indicators and more attention to the disclosure of information in real time. The SEC has thus far taken no serious steps in promoting alternative or supplemental forms of disclosure, although under its new chairman there appear to be slight stirrings of interest. Nevertheless, SEC humility in this area would be well-advised. Companies, accountants and analysts can take the lead, and should.

Indeed, SEC mandates of any kind would be highly counterproductive. As we have seen in the past, SEC requirements quickly produce boilerplate disclosures and stifle innovation. There are sufficient potential benefits for companies in the form of lower capital costs to believe that once the best companies start disclosing additional information—and seeing these benefits—others will feel compelled to follow suit.

On the other hand, the SEC could perform a valuable role without issuing mandates. It could encourage voluntary action—convening groups of companies, dealing with objections, seeking solutions that attract support, emphasizing that investors need information in order to make rational choices. In my experience, companies are highly responsive to requests from the Government for new thinking; what they do not want to do is waste the time of their executives.

In summary, then, there is clearly a current and growing need for information that supplements conventional GAAP financial statements. Indeed, the continued efficiency of our economic system depends on developing this supplementary information. Through the Internet, there are now inexpensive ways that this information could be made available to investors, and a strong basis to believe that both companies and investors will be benefited by such disclosure. What is needed, however, is the will among policymakers and businesses to proceed. This Committee could do much to encourage more attention to this question by the SEC.

Mr. Chairman, that concludes my testimony. Thank you for the opportunity to present these views.

Indicators Source:

Elliott, Robert K., "The Third Wave Breaks on the Shores of Accounting," *Accounting Horizons* 6(2) (1992): 61–85 and Elliott and Peter D. Jacobson, "Costs and Benefits of Business Information Disclosure," *Accounting Horizons* 8(4): 81–82.

Percent of sales from products developed in last x months

Average time to bring a new idea to market

Market's perception of quality of product

Market's perception of quality of service

Percent (or number) of customers accounting for x percent of sales

Customers industry concentration

Percent (or number) of suppliers accounting for x percent of purchases

Suppliers industry concentration

Age of units being replaced

Up-time ratios

Mean-time to failure figures

Customer reorder rates

Percent of revenue from new products

Elapsed time from raw materials to finished goods

Break even time—time required to recover development costs

Jenkins Report: The American Institute of Certified Public Accountants, *Improved Business Reporting—A Customer Focus* *http://www.aicpa.org/members/div/accstd/ibr/ppiv.htm,* February 21, 2000.

Reject rate for products

Patents obtained annually

Customer satisfaction

Number of design and installation contracts received

Ratio of contracts awarded to number of proposals

Market share

Average number of employees

Average consumption of materials per employee

Value of purchased components as a percentage of sales

Product-development lead time

PricewaterhouseCoopers, *Value Reporting Forecast 2000,* 1999.

Six financial drivers: Sales growth rate, operating profit margin, cash tax rate, working capital to sales, capital expenditure to sales, and cost of capital

Four nonfinancial drivers: Process, growth, and innovation, people, and customers

Market share

Share of customer spending

Customer satisfaction

Research and development productivity measured through number of patents per R&D dollar

Size of its new product pipeline

Time between development and marketing

Time spent by employees on product innovation

Relative strength of the company's brands in relation to competitors'

Process costs per transaction

Ranking in cross-industry benchmarking studies

Efficient use of office space

Outsourcing of nonvalue-adding activities to others who can perform more efficiently

Kaplan, Robert S. and David P. Norton, *The Balanced Scorecard,* Harvard Business School Press, Boston, 1996.

Revenue from new products

Gross margins from new products and services

Percentage of revenues from new customers, market segments or geographic regions

Percentage growth of business with existing customers

Number of responses to solicitations, or the conversion rate at which customers responding to solicitations actually purchase goods or services

Solicitation cost per new customer acquired, or new customer revenues per dollar of solicitation cost

Breakeven time, or BET, measures the time it takes for a new product to recover its development costs

Gross margin from new products

Number of employees qualified for specific functions that the company will need in the future

RESPONSE TO WRITTEN QUESTION OF SENATOR MILLER FROM JAMES G. CASTELLANO

Q.1. On March 8, 2002, *The New York Times* ran a story entitled "A Market Solution to the Accounting Crisis" by Joshua Ronen. Mr. Ronen suggests, "instead of appointing and paying auditors, corporations should be able to buy financial statement insurance." He says this would protect investors against losses suffered as a result of misrepresentations in financial statements." And he says it would "redirect the auditor's loyalty to where it belongs: A corporation's employees, creditors, and shareholders." What do you think of this idea?

A.1. We have a number of concerns regarding Mr. Ronen's proposal. His proposal would move the independent audit from one of assurance to one of insurance. In other words, it would shift the auditor's report from one that says to the public that in the auditor's opinion, the company's financial statements, in all material respects, present fairly the financial position and results of operations of the company in accordance with Generally Accepted Accounting Principles. An auditor's report under Mr. Ronen's proposal would say that if there is an error in the financial statements, there is insurance to cover the losses. It would not address the accuracy of the statements. Even if the public believe they would ultimately be paid for any losses suffered as a result of reliance on financial statements containing material error, this would not enhance investor confidence. Knowing that it might be years before any damages are paid is a disincentive. The public needs to feel that the financial statements are materially accurate.

We do not have the insurance expertise to comment on Mr. Ronen's assertions that insurance companies would be happy to have this new business and that costs would not rise as a result of the new insurance product he is advocating. However, reflecting back on the banking and S&L crisis of the late 1980's and early 1990's, when the FDIC sued many directors of failed banks, we note that D&O insurance became extremely hard to purchase and increased in cost exponentially at that time. We note that damages for audit failures can be massive and must therefore question both the appetite of insurance companies to take on such a huge underwriting risk, and the assertion that costs will not increase.

The proposal would have the insurance carrier appoint and pay the auditor to assess the financial condition of the prospective client. Given the cost of an audit, we do not believe that an insurance company would be willing to pay the large audit fee for the assessment, knowing that it would have to swallow the cost if it decided not to insure the company. And a company would balk at paying for the assessment knowing that if the insurance company decided not to give it insurance coverage, it would have to pay for another assessment with another carrier. And if no carrier would insure the financial statements of a company, there would be no protection for the public because the financial statements would be unaudited.

We also believe that insurance companies would base part of their underwriting on the condition of the company, and not the accuracy of the financial statements. If a company fails, or has losses that result in a reduction in its stock price, the probability of a lawsuit alleging accounting irregularities is high. Thus, companies in

poor financial condition that have accurate financial statements would be unable to acquire the insurance, or would have to pay an exorbitant premium for the insurance. And the company would then not have an audit. This would deprive the public of having the assurance that the financial statements are audited.

The interests of an insurance company and the interest of investors are quite different. The insurance company looks to minimize its risks for the protection of its shareholders. It would inject itself into the decisionmaking process that occurs during an audit. And it would do so without the expertise needed to make the appropriate decisions. One needs only look at the managed care field where insurance companies make decisions regarding medicines that can be prescribed, and medical tests and procedures that can be used based an cost considerations, and not on the informed medical judgment of the treating physician. This type of decisionmaking process regarding the conduct and findings of an audit would not protect the public interest.

Mr. Ronen bases his idea on the erroneous theory that the auditor's loyalty is misplaced. That is not true. Seventy years ago the Congress determined that the auditor's independence would not be compromised if the auditor was hired and paid by the company. We continue to believe that the auditor's independence is not compromised because the auditor is hired and paid by the company.

In fact, the success of the profession in protecting the public interest is impressive. Of the small number of instances where there has been an audit failure, many were caused by company fraud perpetrated on the auditor. The profession has been working to upgrade auditing procedures that will ferret out such fraud, and recently issued proposed audit standards that will help to uncover any such attempts.

The balance of the failures are caused by human error—something that will unfortunately occur in every human endeavor. Such failures result in disciplinary action being taken against the auditor. The profession requires an extremely tough and comprehensive exam to become a CPA, and has extensive continuing education requirements and disciplinary deterrents to keep auditors an their toes and to keep the instances of human error at a minimum.

To further ensure that the audit will be free from error, the profession has endorsed unprecedented and rigorous reforms in the discipline and quality monitoring of the accounting profession. While self-regulation has been a hallmark of our profession for nearly 110 years, we appreciate that the times call for such measures to restore investor confidence. This new disciplinary and quality monitoring body would look at independence, auditor performance, and firm quality control on a continuing basis and would help to ensure the highest standards of independence exist in every audit.

RESPONSE TO WRITTEN QUESTION OF SENATOR GRAMM FROM ROBERT E. LITAN

Q.1. Would you provide for the Committee your views as to why there is such heavy market concentration at the top of the accounting industry? In other words, the industry is divided into two groups, the Big 5, and everybody else, with a huge gap in market

share between the two groups. Why is the industry so dominated by the Big 5, and why over the last several decades has the number of firms in the dominant group declined, with no new entrants from below?

A.1. The answer to the questions about how we got to the Big 5 is quite easy: Mergers. Of course, at the time of the various merger, there were those who worried about growing concentration in the industry, but under the conventional yardsticks used to judge mergers, the various transactions passed muster, and if they had been challenged in court, I suspect that Justice would have lost.

As for the lack of new entrants into the upper tier, the explanation is probably two fold. For one thing, there certainly appear to be economies of scale in auditing, although it is not clear at what point they are exhausted. Second, there appears to be prestige value for listed companies to have one of the Big 5 do their audits—at least until Enron. Much the same effect is at work in investment banking, where it is difficult for lower tier firms to break into the top bracket. The open question now is whether in the wake of Enron, some of the prestige associated with a Big 5 audit will wear off and allow lower tier firms to move up. Only time will tell.

RESPONSE TO WRITTEN QUESTION OF SENATOR MILLER FROM ROBERT E. LITAN

Q.1. On March 8, 2002, *The New York Times* ran a story entitled "A Market Solution to the Accounting Crisis" by Joshua Ronen. Mr. Ronen suggests, "instead of appointing and paying auditors, corporations should be able to buy financial statement insurance." He says this would protect investors against losses suffered as a result of misrepresentations in financial statements." And he says it would "redirect the auditor's loyalty to where it belongs: A corporation's employees, creditors, and shareholders." What do you think of this idea?

A.1. This is an interesting idea, with a very worthy objective: Having the auditors work for someone else other than management. Nonetheless, this proposal is likely to have the same practical problems I raised in my testimony with respect to other third parties: How to manage the selection of auditors for over 10,000 listed companies.

There is nothing stopping the insurers from adopting the Ronen solution now; the real question is why no insurer has offered such coverage voluntarily. I suspect it is because of the daunting problems involved in picking the insurer, as well as because no corporation—or precisely, no management—yet sees it within its financial interest to let the insurer hire the auditor.

It is possible that if, by law, listed firms were required to let their audit committees choose the auditor, the incentives might change. With the decision to hire the auditor lodged in some persons outside management, it is conceivable that insurers might develop the product Ronen advocates because there might be some demand for it.

A more direct solution, of course, would be to prohibit companies from hiring their own auditor. This would require the invention of an insurance scheme of the type Ronen suggests. But there is no

certainty at the outset that enough capacity would exist to cover all listed companies. Such a step, therefore, would run a significant risk of leaving some companies uncovered altogether.

These are initial impressions, and it may well be that the Ronen idea could be implemented in a way that surmounts these and possibly other practical objections. I would encourage the Senator's staff to discuss the idea more directly with Ronen.

ACCOUNTING REFORM AND INVESTOR PROTECTION

TUESDAY, MARCH 19, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:35 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

This morning, the Senate Banking, Housing, and Urban Affairs Committee conducts the eighth in a series of reviews of accounting reform and investor protection issues raised by the problems of Enron Corporation, and other public companies. Today's hearing will focus on issues raised by the oversight and regulation of the accounting profession, corporate governance, and stock analyst conflicts of interest.

These issues predate Enron's collapse. We have other examples of the problem. Nearly 20 years ago, the Supreme Court observed:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

The charter of the Public Oversight Board provides the following:

> The Public Oversight Board shall oversee the audit and independent standard setting, peer review, quality control, and monitoring bodies relating to . . . [the SEC Practice Section], which is composed of accounting firms that audit the financial statements of some 17,000 public corporations that file reports with the SEC member firms, in order to represent the public interest on all matters that may affect public confidence in the integrity, reliability, and credibility of the audit process.

There is a sobering comparison to be made between that charter statement and the Resolution of Dissolution that the Public Oversight Board approved unanimously on January 20, 2002, after voting to disband.

We look forward this morning to hearing about the experiences of the Public Oversight Board with the major accounting firms and the SEC, as well as to hearing the recommendations of the Public Oversight Board members regarding regulation of accountants.

I will defer my comments on other matters this morning, corporate governance and stock analyst conflict of interest, until we go to our second panel, which will be directed toward that subject.

Before I introduce our other witnesses on our first panel, I will turn to my colleagues for any opening statements.

Senator Gramm.

COMMENTS OF SENATOR PHIL GRAMM

Senator GRAMM. Well, Mr. Chairman, I will be brief because we have two panels this morning, and we also have a lot going on in the Senate, which is why many of our colleagues are not here. I am going to be in and out myself as we deal with campaign finance reform and as we deal with the energy bill, and an amendment that I am directly involved in.

Again, as I have on several occasions, I want to thank you for the forward-looking nature of these hearings. It is my opinion that Congress, especially the Senate, has not covered itself in glory during this process. I think this Committee has done an excellent job.

I think we have focused on the problem and what we have the legislative responsibility to do to fix it. I continue to believe that our mission is to try to determine what we can do to improve the current process, what are the benefits of making legislative change, what are the costs of making legislative change. And I think we have to come to a delicate balance of the two.

As I have said on many other occasions, I am a firm believer in the legislative equivalent of the Hippocratic oath: First, do no harm. I believe that there are changes that need to be made, and I think there is a consensus for us to act legislatively. I think that this Committee has a very important responsibility in that if we can put together a bipartisan bill, I think it will hold up on the floor of the Senate and will ultimately become law.

We have heard from many good witnesses in trying to focus our thinking on this subject. We have two excellent panels today. I look forward to hearing from them, and I want to thank each of you for coming and sharing your views and your experience with us. We are long on theory, but we are short on practical experience.

I took two accounting courses. I liked both of them. But when they assigned the practice set in the second course, that was the end of my career as a college student in accounting. It was too hard and too boring, and I did not have the personality for it. That is why I got into economics.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you.

Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. I once again thank you for this hearing. After that comment on accounting versus economics, I have a hard time having any kind of rejoinder.

I always thought accounting was exciting.

[Laughter.]

And particularly, I want you to know that I support you completely in that concept.

I will tell you that there was nothing more important than the day that I sat down with our auditors and signed our audited financial statements as a CEO.

So, it got your attention then. It has my attention now, and it is has the country's attention and we will work hard to try to get to a responsible, balanced, and bipartisan view on how we should move forward.

I compliment the Chairman and the Ranking Member for their leadership in this effort.

Chairman SARBANES. Thank you very much, Senator Corzine.

I might say to my colleagues, we have two nominees that, if we get a quorum, we will consider here. If not, we will try to do it off the floor, two members of the National Credit Union Administration Board, on whom hearings were held a week or so ago. We would like to move them along, with the objective of getting them into place before we break for the spring recess.

Our first panel this morning consists of Charles Bowsher, who joined the Public Oversight Board in 1997, and has served as its Chairman since 1999.

We all know Chuck Bowsher very well, of course, because he served as the Comptroller General of the United States—he was with the GAO from 1981 to 1996. He was also a partner at Arthur Andersen and worked with them from 1971 to 1981. He was Assistant Secretary of the Navy for Financial Management from 1967 to 1971.

Aulana Peters is a member of the Public Oversight Board, and a partner in Gibson, Dunn & Crutcher, a law firm that she has been with since 1973. From 1984 to 1988, Ms. Peters served as a Commissioner of the Securities and Exchange Commission. She served on the Financial Accounting Standards Advisory Council to the Financial Accounting Standards Board, and on the Board of Directors for the American Institute of Certified Public Accountants.

They are joined at the table by Alan Levenson, Counsel to the Public Oversight Board and a Senior Partner at the firm of Fulbright & Jaworski. Alan Levenson is a former Director of the SEC's Division of Corporation Finance.

We are very pleased to have this panel with us this morning. Mr. Bowsher, why don't you lead off and then we will go to Ms. Peters and we will proceed from there.

I do not know whether Mr. Levenson will simply assist or have a statement to offer.

Mr. LEVENSON. Supplement.

Chairman SARBANES. All right. Very good.

STATEMENT OF CHARLES A. BOWSHER CHAIRMAN, PUBLIC OVERSIGHT BOARD FORMER COMPTROLLER GENERAL OF THE UNITED STATES ACCOMPANIED BY: ALAN B. LEVENSON COUNSEL TO THE PUBLIC OVERSIGHT BOARD

Mr. BOWSHER. Thank you very much, Mr. Chairman, Senator Gramm, Senator Corzine. It is a great pleasure to be here today.

As you just pointed out, I am joined by Aulana Peters and Alan Levenson here at the table. Norm Augustine, one of our other board members, is out of the country and unfortunately could not

be here. And you have heard from John Biggs before, at another one of your testimonies.

I thought that it might be worthwhile to open with a little bit of history on the regulatory oversight of the accounting profession.

The accountants really got started in this country when the British sent their accountants over from London and Scotland in the late 1890's. There was an organization formed, a predecessor to the American Institute of Certified Public Accountants—the AICPA.

But there was really not that much oversight until we had the great stock market crash in 1929. Then we had Congressional hearings; we had the 1933–1934 Acts passed. In those, Congress mandated—on the advice of some accountants who testified—that there should be an annual audit and there should be accounting standards that the auditors could audit against.

That authority was given to the SEC, but on a vote of 2 to 1, with Joe Kennedy being the Chairman and Justice Douglas being the dissenting vote, they delegated that responsibility to the private sector. It went to the AICPA, which did it for many years.

Actually, Congress did not look again at the accounting profession until the 1970's. What triggered that investigation was the bankruptcy of the Penn Central Railroad, which was the greatest bankruptcy in American corporate life up to that point in time, and the first big one that we had had, really, after World War II.

We also had the "sensitive payments" problems, which meant that some foreign officials were being paid bribes by some of our American companies. The auditors were not told about it and, therefore, did not report it. That was a big issue.

So, we had two hearings in the late 1970's, one by Chairman Metcalf in the Senate, and one by Congressman Moss in the House. Out of those hearings came some advice from Senator Metcalf, particularly to the accounting profession, that the accounting firms ought to go away and come up with what he thought they could devise—a self-regulatory program. That is when they set up the current self-regulatory program that we have, which is headed up by the SEC Practice Section. That is an independent group under the AICPA which the firms have to belong to. Prior to 1977, the firms never belonged to the AICPA, only individual CPA's.

We also at that time started the peer review process to try to check to see how the auditing firms were doing as far as following good standards, good policies, good procedures.

That was tested as a result of the Penn Central bankruptcy when Sandy Burton, the Chief Accountant of the SEC, thought that was something that could be done that would help improve auditing. The auditing firms resisted it, but once they went through it, found that it wasn't all that bad. And so, that was part of the new self-regulatory process.

However, I do want to point out that the new self-regulatory programs, although innovative in their time, and I think really contributed to better auditing over the years here in this country and around the world, where many other features of it have been adopted, there were some doubts.

Sandy Burton, the former distinguished Professor of Accounting at Columbia University, and at that time, the Chief Accountant of the SEC, warned in testimony before the House Interstate and For-

eign Commerce Committee in 1978, that peer review "is likely to be seen as a process of mutual back scratching." In other words, one firm doing the audit—the peer review—of another. He also warned that "it is highly doubtful that a part-time POB can either in fact or in perception" provide an effective substitute for statutory regulation.

Harold Williams, Chairman of the SEC at that time, said that the "effectiveness and credibility of the Public Oversight Board depends on its independence, including its willingness to be critical when called for and its ability to make public its conclusions, recommendations, and criticisms." Chairman Williams also made the point that an effective POB could only be effective "if it is not impeded in performing its functions and responsibilities."

Now a quarter century after those reforms, I believe events of the recent months here in the last 2 years demonstrate that the warnings of Dr. Burton and Chairman Williams have come to pass. I have come to the conclusion, as my fellow board members have, that the voluntary, self-regulatory program needs to be replaced because it has failed to keep pace with the challenges faced by the profession. More troubling is the resistance of the profession's trade association, the AICPA, and several of the Big 5 firms to really embrace major reform.

Arthur Levitt, the former Chairman of the SEC, also described this problem in recent testimony before your Committee when he said that "more than three decades ago, Leonard Spacek, a visionary accounting industry leader, stated that the profession could not 'survive as a group, obtaining the confidence of the public . . . unless as a profession it had a workable plan of self-regulation.' Yet, all along the profession has resisted meaningful oversight." And he was really talking about the period from 1943 to 1973.

In 1980, the SEC said in a report prepared for the Senate Committee on Governmental Affairs that the POB had an obligation to "serve as the conscience and critic of the self-regulatory effort." The POB's charter, which was completed a year ago, provides that the POB is "to represent the public interest on all matters that may affect public confidence in the integrity, reliability, and credibility of the audit process."

In the last 2 years, we have had several unfortunate situations. One was that in May of 2000, after the POB had been asked to do some special reviews of the major accounting firms, to see if there were independence problems at their firms. This request came after PricewaterhouseCoopers had had a special review and 8,000 infractions were reported. Some of those were technical, but there were at least 200 fairly serious ones that the chairman of their partnership acknowledged.

We went forward with the request that the SEC asked us to do, to do a review of the other four big firms. Much to our surprise, we had our funding cut off, something that had never happened in over 20 years. And Mel Laird, who is a former Congressman, nine-term Congressman, former Secretary of Defense, and the longest-serving member on our POB, who was still on the POB at that time, said it was the "worst incident in my 17 years" on the POB.

Following the decision to cut off the funding of the POB's special reviews, the SEC and the Big 5 did come into agreement on how to do the reviews by splitting them into two efforts.

One, a look back where they asked each firm to hire a lawyer which the SEC would agree upon, to look back and see how many infractions there were. And then the look forward, which we were supposed to do, and look forward to see how well the new systems that the firms had implemented, were working along with the training, the leadership, and everything like that.

Unfortunately, after 21 months, we have not been able to do those reviews and, again, we just ran into various delaying tactics.

Then, of course, it took over a year to get our charter approved. Norm Augustine, one of our fellow Board members, said that after a while, one gets very discouraged that people cannot come into agreement faster on something like just a charter.

But I think the precipitating event that caused us to terminate, as you pointed out Mr. Chairman, in January, was the proposed new regulatory structure that the Chairman of the SEC, Harvey Pitt, presented for the accounting profession. This plan was worked out in private talks between the SEC and the AICPA and the Big 5 accounting firms, with no input from the POB, which repeatedly had been assured that it would be consulted.

This new proposal effectively rendered the POB a lame duck. The POB believed it could not oversee the activities of the accounting profession under the circumstances, and that it would mislead the public to appear to do so.

Furthermore, the POB was concerned that if we were to continue in operation during an interim period before the new governance structure was in place, it would leave the impression that it approved of the new proposal that the SEC had put forward, which we did not approve.

As the "conscience and the critic," the POB felt it had no choice but to disband. We felt that only by so acting could we protect the public interest. What the POB did was really akin to what the auditor does when it believes it must resign from a client engagement because of a fundamental disagreement with the client.

Now attached to my testimony, Mr. Chairman, are copies of the letters I sent as Chairman to Mr. Pitt on January 21 and January 31, detailing our decision to terminate. These letters are attached as Appendix A and Appendix B.

Chairman SARBANES. Your statement and the attachments will be included in full in the record.

Mr. BOWSHER. We appreciate that, Mr. Chairman.

What we have proposed today in our White Paper is a new regulatory structure that we think the accounting profession needs and we believe that, to be effective, it must be totally independent of the accounting profession and it must be based on the foundation of Congressional action in creating a new, self-regulatory organization. If you look at the chart that we have—it is the last exhibit on the White Paper. It is also in the testimony. It shows the new format for this new oversight board that we would recommend.

We recommend that the Congress create a new Independent Institute of Accountancy and center all regulation under its auspices. A seven-member board would run the institute totally independent

of the AICPA, the Big 5, and other firms. The chair and the vice chair would be full-time employees of the institute. Five other members, or thereabouts, whichever mix they would like to make, would serve on a part-time basis. We suggest that they all be appointed by a panel composed of the Chair of the SEC, the Chair of the Federal Reserve, and the Secretary of the Treasury. Once named, the chair of the new board would also join the other three in naming the other members of the board. The members could only be removed by a vote of two-thirds of the board itself.

The SEC, as we show on the chart, would have oversight of this new IIA Board, and the SEC's Office of Chief Accountant would have the liaison, we assume, to this new self-regulatory group in the private sector.

If you look on the left-hand side, what we show is that all three of the standard setting bodies would be under this new board. In other words, we would bring the accounting principles—the Financial Accounting Standards Board or the FASB—under this board. We would also bring in the auditing standards and the independence standards. So that you would have all the standard setting under this new board.

Then the new board would also have the ability to do reviews, both annual reviews, which would replace the 3 year peer review that we have historically had, as well as special reviews done by the professional people in this organization.

The board would also have the enforcement and the discipline, the continuing professional education and the international liaison.

We feel that it is very important to get all of the functions of the accounting world, you might say, under this one oversight board, which then could act as different problems come up.

In other words, if there is a problem in accounting, the accounting principles would be within it. Sometimes you need the auditing standards to tell you what is the effect or the auditability of a new FASB standard. Right now, they have to do it on an informal basis.

The independence group, of course, was established with the Independence Standards Board—the ISB—a couple of years ago, but then was disbanded. This proposal would bring it all back under one independent board.

I might also say that we see the funding here being provided through fees imposed on public corporations in amounts sufficient to cover the costs of this institute. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds as it did in May 2000.

Now beyond setting up the new institute, we are recommending certain other issues to be considered by the Congress.

With regard to nonaudit services for audit clients, the POB recognizes that there has been disagreement on restricting scope of services and that various models have been suggested for what should be allowed and what should be excluded.

The POB strongly agrees with a point made in President Bush's 10 point reform plan that "Investors should have complete confidence in the independence and integrity of the companies' auditors." The specifics of the President's plan recognize the importance

of prohibiting certain nonaudit services in order to safeguard auditor independence.

We take note of a statement issued by the AICPA on February 1, 2002, in which it affirmed that it "will not oppose Federal legislation restricting the scope of services that accountants may provide their public audit clients, specifically in information technology and internal audit design and implementation."

Against this background, the POB proposes that the SEC regulations concerning independence be legislatively codified with appropriate revisions to update restrictions on scope of services involving information technology and internal audit services as noted above. At the same time, the POB believes such legislation should affirm that tax work not involving advocacy and attest work by the audit firms in connection with SEC registration and other SEC filings be allowed.

Now, I know that other witnesses before your Committee have raised concerns—the AICPA especially—about cascading effects down to the smaller auditing firms and to the smaller businesses in this country.

The POB believes that small public businesses, to be defined by the SEC, should not be subject to any restriction on nonaudit services for their audit clients. Further, with respect to the nonpublic corporations, it is the POB's position that such corporations and accounting firms that audit them should not be subject to any restriction on nonaudit services. We expressly emphasize this to avoid misunderstanding and any consequences to small business and small audit firms.

We are also recommending that the auditors should be rotated every 7 years. Right now, there is a rule in the auditing world that the partner has to be rotated every 7 years. We believe that the time has come now to consider rotating the firms themselves. John Biggs, one of our fellow members strongly believes in this.

We think, as a corollary, public corporations would be prohibited from firing auditors during their term of service unless such action is determined by the audit committee to be in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC.

Another area that we want to make a recommendation on is the revolving door. We believe that engagement and other partners who are associated with an audit should be prohibited from taking employment with the affected firm until a 2 year cooling-off period has expired.

I know, Senator Corzine, in your bill, you have 3 years, and that, too, would appear to be reasonable. But we do believe that we need a cooling-off period. For many years, all of us have tried to avoid that with some oversight by the auditing firm. But in recent alleged audit failures, there have just been too many incidents, it appears, of having too many people from the old auditing firm in the senior financial positions of the audit client.

We would also recommend that the institute expand on the recommendations of the recent Blue Ribbon Committee. I know you are going to have Chairman Whitehead, who was Co-Chairman of our Blue Ribbon panel, on your next panel, Mr. Chairman. But we

would recommend, too, as I believe he does in his statement, that it be made clear that the external auditors should be accountable to a firm's board of directors and its audit committees, and not to management. Specifically, the audit committee should take responsibility for hiring, evaluating, and, if necessary, terminating an audit firm.

Another item that we would like to bring up is a proposal to discourage conflicts of interest involving public corporations, we think that Congress should amend the Securities Exchange Act of 1934 to require more meaningful and timely disclosure of related-party transactions among officers, directors, or other affiliated persons and the public corporation. Such disclosures should be made promptly in current reports as well as in proxy statements filed with the SEC.

The last item that we highlight in our testimony today is that management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. This is a recommendation that was made in the General Accounting Office report in 1996, to improve the auditor's ability to provide more relevant and timely assurances on the quality of data beyond that contained in the traditional financial statements and disclosures. Both the POB and the AICPA at that time supported the recommendation that the GAO made, but so far, the SEC has not adopted it. I would hope they would at some point.

Now, let me just say in closing that a decade ago this Banking Committee in the Senate was in the forefront of enacting major reforms for the banking industry, reforms that were really widely opposed by the banks and their lobbyists. Opponents then predicted gloom and doom for the industry should the proposed reforms be enacted. In reality, the reforms contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 repaired flaws in regulation of the Nation's banking industry. More important, they significantly strengthened the industry.

I am pleased that you have Bill Seidman here today as a witness because I think Bill's work during that period was outstanding for our country.

Today, the Congress again is called upon, I think, to institute reform. In the wake of the Enron debacle, the POB, acting as the "conscience and the critic" of the profession, strongly believes that to protect investors and the public, the old system of voluntary self-regulation for the accounting industry must be replaced. While many will urge that the Congress act with caution and that the profession be again given the opportunity to fix the present system with marginal changes, the POB believes it is time to resist the continuation of the status quo and move ahead with fundamental change.

Mr. Chairman, you recently made the point that recent events have had a critical impact on the national confidence in the financial markets, and that the time has come to focus on the protection of investors and the efficient functioning of our capital markets. I could not agree more. That is why I believe it is time to resist the continuation of the status quo and move ahead with fundamental change.

Mr. Chairman, that concludes my prepared testimony. I would like Aulana to be able to give hers, and then we would be happy to answer any questions.

Chairman SARBANES. Thank you, that was extremely helpful.

Ms. Peters, we would be happy to hear from you.

STATEMENT OF AULANA L. PETERS
MEMBER, PUBLIC OVERSIGHT BOARD
FORMER COMMISSIONER
U.S. SECURITIES AND EXCHANGE COMMISSION
RETIRED PARTNER, GIBSON, DUNN & CRUTCHER

Ms. PETERS. Good morning, Mr. Chairman, and Senator Corzine. Thank you very much for giving me this opportunity to speak to you today and share my views on what may be necessary as reforms to the self-regulatory structure of the accounting profession.

I would like to emphasize that the views I am about to express are based on the observations I was able to make as a member of the Public Oversight Board.

Indeed, as a part of our oversight responsibilities, I have begun to come to the conclusion that some changes were needed long before the Enron scandal was emblazoned across the press and the problems of Arthur Andersen started to surface. I emphasize that because, of course, I recognize Enron has created a circumstance or a situation where things have become more urgent and the perception of the need for change has become more urgent.

I agree that instead of permitting change to evolve as it has in the past, this crisis suggests that the change should be radical and immediate.

Again, before launching into the specifics of my testimony, I would like to further emphasize that I had an opportunity over the past year to observe the workings of certain aspects of the self-regulatory organization that currently exist, and I have concluded—my problems with the structure, with the system, lies in flaws that I perceive in the structure of the system and not necessarily in any competence of the individual professionals who are currently working within the system to set standards, impose discipline, examine audit failures for systemic changes.

These people are dedicated. They are very bright and they work hard for the only reward given to them, which is to further the profession and its perception. It is just that times have changed and we have to move forward in a different process.

Now, Chairman Bowsher has already indicated that members of the Public Oversight Board are in agreement that the change needs to be brought about by legislation.

I would like to point out a couple of reasons why I personally believe that legislation is very necessary here, as opposed to letting it come about in some other way.

First, legislation would provide the new entity, whatever that is called. We call it the institute, and with your patience and indulgence, I will refer to this entity that is yet to be created as the proposed institute. It would permit the institute to have a statutorily defined base of authority, which I think is critical. That would put it in a situation where it wouldn't have to continually renegotiate or discuss exactly the parameters and the scope of its authority.

Second, legislation should, and will clarify the institute's ability to conduct operations by providing it with a permanent source of funding.

Now, I fully realize that nothing is permanent on this earth or in our world. But it is a lot better than being subject, again, on an annual basis or any other periodic basis, to negotiating with those that you regulate or those who are affected by your regulation, for money to proceed with your processes and your operations.

So, I think that that is also very key as well, and it is a point with which we differ with respect to what I understand the SEC proposal is.

Finally, legislation I believe is the most effective way to streamline what former SEC Chairman Levitt and others have called the alphabet soup of governance that currently exists in the profession.

Ladies and gentlemen, I do not think that you can look forward to any effective streamlining taking place as a result of negotiation with the parties involved. The Congress of the United States is going to have to take a position and bring, I hope, and I would recommend, all of the different elements that constitute the corporate governance or the governance structure applicable to the accounting profession under one umbrella, so that there is coordination and immediate flow-back and a single agenda within that organization, so that the profession can move forward effectively to do its job, and the self-regulatory entity can move forward effectively to do its job.

Now with those comments about general legislative basis, I will just briefly comment on the benefits that I perceive would come from adopting the structure that the POB has proposed here.

First, peer review, of course, has been a sacrosanct element in the structure for many years. I agree with Chairman Bowsher that it has served the profession well in many respects, particularly with encouraging the implementation of good quality control systems. However, I also believe that our recommendations which also stems from the recommendations of the POB panel on audit effectiveness, and I suppose fair and full disclosure would require me to remind the Committee and I was a member of that panel, and you may take my views in that context.

It does replace the triennial review with an annual review by the firms with oversight by the regulatory entity and it expands and provides for the expansion of the nature of those reviews, as I understand it, to include more pointed and specific expertise being brought to bear on the systemic reviews, or the review of the systems. But most significantly, the oversight of those reviews would be conducted by the institute's personnel, thereby eliminating any perception of the fact that the peer reviews are done in a clubby atmosphere where individual firms may be unwilling to criticize their competitors because they do not want to set themselves up to be criticized in the future themselves.

Another key difference would be that the POB's recommended process, would not exclude from this annual review audits that are known to have problems, audits that are already the subject of litigation or governmental investigation.

That I believe is key for the process to have a diagnostic value, to help you understand what went wrong so that you may be in a

position to adopt standards or take other steps to prevent the same thing happening in the future.

Leaving peer review for a moment and going to the proposed changes that would relate directly to discipline, this is an area that really needs to be changed significantly. I think the processes that exist currently are divorced—the disciplinary processes are, in essence, divorced from the standard setting process.

So although there is feedback and the current structure recognizes and the individuals operating the current structure recognize the need for feedback, that feedback takes a while for it to go through channels where what we know as the QCIC committee and the Peak Committee—QCIC is the Quality Control Inquiry Committee. And the Peak Committee is that committee that deals with regulation or discipline for individuals, as opposed to firms.

If they were brought together, you would not have a separation between trying to determine what problems stem from systemic flaws and what problems are related to bad judgment. And a lot of the audit failures are related to bad judgment of individuals in the field, which is how you come to have good peer review reports and failed audits within the same timespan or time period.

It is important to bring all of these elements, including standard setting. I want to emphasize that I think it is very important to bring standard setting into the same bailiwick to be conducted under the same umbrella as discipline.

I think I will limit my comments to the structural changes that we have recommended to those that I have just made, and go on to add my 2 cents, so to speak, on the issue of why the POB decided to resign. It is a very important issue and I would like to share my views or add my views to those offered by Chairman Bowsher. And what he has stated, I completely accept, embrace, and endorse.

I do not have a different take on it, but I would like to outline certain facts that are very important to me, and were important to me in coming to the conclusion that my colleagues and I were correct in voting to disband the Public Oversight Board, which, incidentally, was a post that I really looked forward to spending 7 years working at.

The facts are that on December 4, we were all in Washington and the POB learned, after the fact, that the Chairman of the SEC had met with representatives of the accounting profession to discuss the implications of the Enron disclosures and the implications that those disclosures would have for the self-regulatory structure applicable to the accounting profession.

Later, on January 4, Chairman Bowsher and I, along with our Executive Director, Jerry Sullivan, attended a meeting of the Executive Committee of the SEC Practice Section. That is that part of the AICPA responsible for regulating those auditors who audit publicly held accountants.

During that meeting, we learned from an offhand comment that the committee was actually working on a proposal that they intended to submit to the SEC and that they thought would be—it was said that it would be made public within a couple of weeks, or a few weeks, in anticipation of hearings being held by the Senate, or other Congressional committees.

Quite frankly, I was surprised. I looked at Chairman Bowsher and he was surprised, as was Jerry Sullivan.

At that time, I personally asked the gathered professionals to make sure that the POB was brought into the loop on this issue. I emphasized that, while our role was one of oversight and I had perfect understanding of the limitations of oversight, that I thought that it was very, very important for us to have an opportunity to conduct that oversight because, as we well knew, ultimately, whatever was made public, whatever structure was proposed, the public and Congress would expect us to comment on it. And that we thought we should have an opportunity to understand it, to learn about it, and, if possible, to have some input into it before the fact.

Well, on January 17, I learned through the staff of the POB that SEC Chairman Pitt was in the process of conducting a press conference, that was being televised. This was the first I had heard the public announcement of the proposal that was being made. Of course, Chairman Bowsher and our Executive Director learned about it an hour or two before.

Now, for me, it is key that the Public Oversight Board, which currently is the only independent body being charged with overseeing the accounting profession and with its self-regulatory efforts, assigned with the duty to act in the public interest, that for that entity to be excluded from the process that is dealing with an issue of great moment for the profession, is really not tolerable.

I personally am not particularly concerned about whether the fact of exclusion was intentional or whether it was the unintentional result of bad timing. I really do not think that that should be a focal point of our consideration or an issue for debate in the public or private arena.

But it is without a doubt the fact that the exclusion occurred created a circumstance in which the entity that was charged with being the eyes and the ears of the public in the process lacked information, was in effect, in an informational vacuum. And without the information, without conducting the oversight, one can hardly advise or make any recommendations to either this body or be in a position to protect the public.

With that, faced with those circumstances, my colleagues and I at the Public Oversight Board thought that we had no, and I believe did, have no alternative, if you were to remain principled and act with integrity, but to disband, because to continue to pretend to be in the role, we would find ourselves perhaps misleading those who were watching us and counting on us to be in the position to protect the interest of the public.

Now protect the interest of the public, we must keep in mind, was to observe the process, draw our conclusions about the process, and then report on the process. If we cannot observe the process, we have no basis to draw conclusions and we cannot make any forthright, honest report.

I have nothing further to add to the written statement that has already been submitted, and I am happy to try and answer any questions that you may have for me.

I am sure that Chairman Bowsher is also.

Chairman SARBANES. Very helpful testimony. Did you want to add anything else, Mr. Levenson?

Mr. LEVENSON. Not at this point, but thank you, Mr. Chairman.

Chairman SARBANES. Thank you all very much. We very much appreciate this panel. We particularly appreciate also the extensive White Paper that the Public Oversight Board has submitted to the Committee. That is going to be extremely helpful.

I must say, Ms. Peters, it is hard for me to understand how it could have been expected that a proposal would have much credibility if there was a failure to consult or involve in the process of developing the proposal the Public Oversight Board, or, for that matter, a number of other interested parties as well. Obviously, that is exactly what happened.

A very quick, in a sense, almost secret, consultation that then came forward with a proposal, did not get much traction. And obviously, one purpose of these hearings is to avoid that kind of situation and examine the basis for proposals.

I want to ask some very specific questions because, as they frequently say, the devil is in the details.

First of all, what do you see the relationship being between the SEC and the institute, as you have outlined it? I know you have the SEC in a box up above the institute.

Mr. BOWSHER. Yes.

Chairman SARBANES. What does that mean? How would that work?

Mr. BOWSHER. Yes. Well, we definitely see the SEC of having the oversight over this self-regulatory group, very much like they do with the New York Stock Exchange and the NASD.

Traditionally, within the SEC, the executive group that has done the liaison and oversight role has been the Office of the Chief Accountant. So, we would see that as being the way it would be organized. And the SEC would, as they always say, have the club in the closet. In other words, if the institute and its various components aren't doing the job to their satisfaction, they could certainly bring the club out occasionally and point that out.

We definitely see Government here. But we do not bring the unit into Government. In other words, we keep it in the private sector, funded in the private sector for several reasons.

Chairman SARBANES. Is the club a public disclosure and criticism, or even private disclosure and criticism, or does it involve the power to actually do some of the substantive things that are the responsibility of——

Mr. BOWSHER. I think they have by law the power.

As a former Commissioner, I think Aulana could testify that they have the power to make decisions if the private-sector oversight board is not making decisions in a certain area.

Ms. PETERS. I would wholeheartedly agree. The key is that this entity is being set up to, would be set up to regulate the accounting profession to the extent that for that portion of the profession that is involved in examining and reporting on the financial statements of publicly held corporations. And that is just a fraction of the entire profession and we must remember that.

The SEC is the primary regulator and overseer of our markets and our financial reporting process and should remain so. The SEC will be always having the authority to bring lawsuits and administrative proceedings against accountants and accounting firms for

violations of the law. This private entity, this institute, will have to also, to the extent that it is going to be making rules and setting some standards, but especially disciplinary rules, might want to pass those rules by the SEC.

As well, there is a well-established precedent for self-regulatory organizations. I do not view the institute as the traditionally self-regulatory organization. But for these types of institutions to work under the aegis of the SEC and, in fact, that is what happens right now on an informal basis. It is just that the structure has not been formalized.

Chairman SARBANES. It could be argued that the SEC currently has the authority to do a great number of these things, but they just haven't done it.

Mr. BOWSHER. Yes.

Chairman SARBANES. In the face of all kinds of pressures of one sort or another, which we are all very mindful of. I take it that is one of the reasons that you are recommending so strongly that there be a statutory basis for this regulatory organization. Is that correct?

Mr. BOWSHER. That is correct, Mr. Chairman.

Chairman SARBANES. Now, I want to address the cascading issue for a minute because it has been raised again and again by people in the profession. There are Members of this Committee that are sensitive to it.

In my own mind, I had drawn a very sharp line at the public company and the nonpublic company, on the premise that once you go public and go into the markets and investors then can buy and sell your stock, you assume a different set of responsibilities. And that has been the premise of the securities law.

You draw the line in a somewhat different place because you have a category in there of small public companies that are not going to be subject to the same limitations, whose auditors will not be subject to the same limitations as the auditors of the large public companies.

Mr. BOWSHER. Yes.

Chairman SARBANES. Now that creates an opening that can be expanded, or, indeed, contracted. But, presumably, the pressure would be toward expanding it. Why do you create that additional category?

Mr. BOWSHER. We create it primarily because there is concern that some of the smaller private companies are out there being audited by some of the smaller CPA firms.

Chairman SARBANES. The smaller public companies.

Mr. BOWSHER. The smaller public companies. And when the SEC did their rule last year on the scope of service, they provided that kind of a group. We were saying that we would certainly be, as outside people, advising you, recognizing that that could be done here, too, in the same way as the SEC did it last year.

I think they said anything under $200 million in sales, this would not apply. I think it could go the other way, too, and just draw the distinction, as you say, Mr. Chairman, between public companies and nonpublic companies.

But we would not want this whole concept to not be considered by the Congress because people in the smaller communities and in

the smaller businesses and in the smaller CPA firms think that they are going to get a cascading effect down on them because of what we are proposing here, which is primarily for the larger public companies. And when you think about it, it is a kind of unique situation.

The Big 5, and I am seeing here possibly going to a Big 4 of accounting firms, audit 85 to 90 percent, not only of the U.S. public companies, but also of the world's public companies. It is a very high percentage.

These are very large auditing firms and these are very large corporations. And as I have said in some of my speeches, when one of these big business failures takes place, like Enron, there are great ramifications, great losses to many, many people. And we have to try to put an oversight function in here that reduces the number.

We do not have a large number, actually. We have about 50 accounting failures every year that are brought to our attention, out of over 10,000 audits. But when we have as many of the larger ones as we have had recently, that means a lot of people get hurt. And so, we have to try to reduce that.

So the real emphasis here is to try to bring all the functions together under one accounting board that is independent, overseeing this, under the SEC, is to try to really strengthen the accounting and auditing. And we would be more than willing to see it broken strictly between public and nonpublic. That has been a really great tradition.

We would not want this new effort to be turned down because some people would be concerned about how would that affect the smaller CPA firms.

I have been in this profession for nearly 50 years now and I have seen a lot of reforms. Every time we go through a major reform—I can remember back in the 1960's when we were voting to not allow CPA's to take stock in their clients to make the profession more independent—everybody said, oh, that will be the end of the small CPA firm. I think it hasn't happened.

In other words, we have had to make reforms. After the Penn Central bankruptcy, the New York City fiscal crisis, the banking crisis, and the S&L crisis, we have always had to come up with reforms and straighten out certain areas. And we have always raised the issue of what effect does this have on the small CPA firm in Taylorville, or my hometown of Elk Heart, Indiana. And we have to be concerned about that. No question about it.

We are more than willing to take some kind of grouping in there if we can get the reforms for the large organizations. But you could easily do it the way you suggested, and that would be public companies versus private and nonpublic companies.

Chairman SARBANES. Yes. The logic for that is stronger because the logic is, once you go public, you assume certain responsibilities.

Mr. BOWSHER. Exactly.

Chairman SARBANES. I am going to yield to Senator Corzine. But let me ask one quick question—the independent funding.

Mr. BOWSHER. Yes.

Chairman SARBANES. Could you just sketch out very quickly how you would expect that to be done?

Mr. BOWSHER. Again, there we believe that it would be much better if the corporations, the large public companies in this country, financed this self-regulatory process, rather than relying upon the auditing firms to do it.

We have had the experience over the years with the FASB of trying to raise the money on a voluntary basis through the FAF, and their trustees. It has not been very successful.

Chairman SARBANES. I think it is clear that the voluntary does not work. You go around with a tin cup to the very people——

Mr. BOWSHER. Exactly.

Chairman SARBANES. Well, the very experience you had where they cut off your funding.

Mr. BOWSHER. Right.

Chairman SARBANES. The classic example. So let's assume we are looking for a mandatory source of funding.

Mr. BOWSHER. Yes.

Chairman SARBANES. What should it be and how would it work?

Mr. BOWSHER. We think it would work here, as I say, with fees imposed on the public corporations and it would be a cascading arrangement with the biggest to the smallest and a percentage, sufficient to cover the cost to the institute. In other words, when they made registrations like the 10–K's with the SEC, there would be a fee and that fee would go to finance this oversight group.

Chairman SARBANES. Who would set the fee?

Mr. BOWSHER. Did we have that? It was the institute, I believe is the way we had it.

Chairman SARBANES. How do we then address the argument, which I am sure we are going to hear, that the institute setting its own fees, which are mandatory and automatic, is going to have a gold-plated budget and that you cannot allow the prospect of this incredible cost being imposed?

Mr. BOWSHER. We would definitely give the SEC oversight of that funding thing. We would like not to get it into the appropriations process of the Congress, Mr. Chairman.

Chairman SARBANES. All right.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

If you wondered where Taylorville was, that is a small town in central Illinois, of about 8,000 people, which Mr. Bowsher is appealing to my good instincts about.

[Laughter.]

Chairman SARBANES. I appreciate that the Illinois caucus is at work here.

[Laughter.]

Mr. BOWSHER. I went to the University of Illinois and that is why I know where Taylorville is.

[Laughter.]

Senator CORZINE. I appreciate the testimony—a thoughtful view of both current circumstance and suggestions on going forward.

This cascading issue that the Chairman talked about is certainly an important one. You have taken on another issue in your recommendations that is very challenging to sort through to the right answer, and it is the streamlining of the alphabet soup issues, the

independence of the activity of FASB relative to SEC and putting it inside the institute.

It is one that I must say I am torn with when I think about this issue, whether FASB, which is already, many would argue, slow-moving, with regard to dealing with accounting standards, whether this process would separate it from its fundamental relationship with the SEC, slow down that process further. Why is that coordination so important or not important? The pros and cons of that I would like to hear you discuss.

Mr. BOWSHER. Sure. I will give you two examples. One of the big issues that the auditors and the corporate financial reporting has faced here in the last year or two is the growing concern issue. In other words, will a dot com firm, for example, continue to be in business at the end of this year when the audit is done—you have to make that decision? When you look at the auditing standards, they have certain requirements, and when you look at the accounting principles, they have certain requirements in that kind of a decision. And what we have today is two very separate groups and they do not always coordinate.

Another good example is when the new FASB ruling came out on derivatives, or on this doing away with pooling, you then have to go in and do different auditing. And the question was, did the auditing people get properly consulted as part of the accounting?

I think maybe the most important area would be when you have a situation like the Enron situation, where it obviously, it looks like, at least, we do not have all the facts yet, but it looks like there are some accounting principles issues. It looks like there is some auditing standards. And it certainly looks like there is some independence standards issues.

You would have one board that would be looking over and making sure that all three areas were looked at and properly looked at when we would have these kinds of situations.

Now, literally, the chief accountant of the SEC has to get on the train or the plane and fly to different places and try to get everybody coordinated and that. So it is really the coordination and getting more oversight. See, the auditing standards has never really had any real oversight until we were given it in this last charter. And then, of course, when we go out of business, why, they no longer will have oversight.

In Chairman Pitt's program, they wouldn't have oversight in the future. And the Independence Standard Board, when they went out of business, again, we no longer have oversight.

What we are saying is, we think, as Aulana pointed out, you have to get this alphabet soup, which was a term of art that Chairman Levitt used, brought into some kind of coordinated function. And I really think with the FASB, we are not in any way trying to slow down the process and put more oversight over it.

I think we are putting oversight over it, but I would think that they would try—one of the things that the board would ask them to do is to try—to get the process a little more efficient and a little more timely.

Senator CORZINE. Taking that one step further, do you have an opinion about principles versus rulemaking and FASB, which we are hearing much discussion about?

Mr. BOWSHER. Yes, you are hearing a lot about that.

I have always thought that the rules were very complicated. In other words, I remember when I was Comptroller General, I issued a big report on derivatives and I recommended that FASB come with new accounting standards. I was astounded to see the document that came out.

So, I think it would be good to go to more principles, but I am waiting to see the advocates of just how they are planning to do this because they talk about it, but I haven't quite seen how it is going to be done.

Senator CORZINE. Is the International Accounting Standards Board a program of principle delineation that you would embrace?

Mr. BOWSHER. I have always been kind of a big fan of that effort because I truly think we need international standards. I think most people do not realize how much American money is invested overseas, where they are investing in companies that do not have the best financial reporting.

I really think we are in a global market. We are in a need for global standards. And the Europeans and people overseas really are kind of shocked to see how complicated and detailed our standards are. They tend to go the principle route.

One of the things about Paul Volcker taking an interest in that whole area is that I was hoping that we would get some harmonization, and the Americans may be giving up some of the detail in some of the rule and getting a little bit closer to the principle. But, also, getting some of the Europeans to come a little closer to us on some of the issues, because they have some of the features in their accounting that is not very good.

Senator CORZINE. I have some more questions, but——

Chairman SARBANES. Go ahead.

Mr. BOWSHER. Aulana would like to add one thing, if she could.

Ms. PETERS. You raised the issue of independence. I know that there are different proposals.

Senator CORZINE. With regard to FASB.

Ms. PETERS. With regard to FASB, not with regard to the makeup of the institute's board.

Senator CORZINE. Right.

Ms. PETERS. As opposed to some other board.

Senator CORZINE. I think that is an interesting subject as well.

Chairman SARBANES. Why don't you address that?

Senator CORZINE. Go ahead.

Ms. PETERS. We believe that it is very important for the entity's board to be completely independent of the profession. I know that it may be viewed as logical to look at other self-regulatory organizations as an example of how this organization might operate. That is to say, with only, for example, a majority of the public, of the membership, being public members.

However, I urge the Committee to understand the differences between a New York Stock Exchange and an accountability or an accounting board that is regulating the accounting profession.

The institute that we are recommending that you adopt or the entity that we are recommending that you adopt, is going to be charged only with standard setting and discipline. They will not have a business to run.

The New York Stock Exchange does have a governing board of directors that has some public members and some members from the profession that are currently actively involved in the profession. The New York Stock Exchange is, in addition to a disciplinary organization, a business. And it makes sense to have that input from the businesses that it regulates into the business aspects of its operations.

Chairman SARBANES. What do you mean by completely independent? Do you mean that they should not be accountants?

Ms. PETERS. No, not at all. You need the expertise in oversight of standard setting. What I mean is that they should not currently at the time be partners or affiliates of accounting organizations.

I, for example, had a pretty close relationship to the accounting profession in my other life. Incidentally, Chairman Sarbanes, I am a Retired Partner of Gibson, Dunn & Crutcher.

Chairman SARBANES. We were trying to elevate Gibson, Dunn & Crutcher.

[Laughter.]

Ms. PETERS. I am sure that my former partners are very pleased with that and I will remind them that I was trying to do them some good on this visit to the Hill.

[Laughter.]

But coincidental with my taking on responsibilities as a member of the POB, I retired and resigned my partnership at Gibson, Dunn & Crutcher so that there would not be any question, the less I brought with me, my background and experience as a defense lawyer who spent two decades or more representing the accounting profession.

So there are many individuals—retired partners, retired leaders of the profession—that could bring to this institute a world of experience and a wealth of experience, without being the CEO, the current CEO, of the accounting firm.

Senator CORZINE. Let me take a slightly different tack and less user-friendly.

The peer review process, we had a discussion with some folks from the industry who were arguing—I wasn't actually sure what their answer was—about whether there had been peer reviews that ever resulted in a negative review. I think we got into this cascading issue. I think there had been negative reviews for small firms, but not for large firms.

Mr. BOWSHER. Yes.

Senator CORZINE. But it wasn't perfectly clear what happened there. I understand that there are no disciplinary actions or other activities with regard to the Big 5 or with regard to publicly-traded companies. And it is a strange phenomenon when you have as many restatements of earnings and you said, I think Mr. Bowsher, 50 problems noted, major problems noted in audits during a given year, as the average.

Why hasn't there been a larger hue and cry, until we have an Enron-like problem raised? And that doesn't mean that there have not been voices with regard to this. Certainly, Chairman Levitt has done that, and others as well.

Why hasn't there been this move to rationalize the elements of the industry before? What lessons do we draw from that as we try

to deal with the current situation? And is there a problem with POB itself for not raising some of these issues in a more visible manner to those of us who are responsible for public policy?

Mr. BOWSHER. The POB over the years had a series of reviews and reports that did raise many of these issues. One of the panels that we had was just in the last 2 years, the O'Malley panel, where they raised many of these issues, too.

But in the peer review process, that is where they are really checking out to see whether the auditing firms are following the standards, the procedures, the policies that they are supposed to be following when they do an audit.

It does not generally get to one of the problems that Aulana raised in her opening remarks that sometimes, at the end of an audit, you have to make some decisions. In other words, are you going to sign that certificate, even though there are certain problems facing you? Are you going to qualify that certificate, and things like that?

And sometimes, decisions are made that ultimately turn out not to be the right decisions.

We have another process called the QCIC process, the Quality Control Inquiry Committee, to look at that. And that would generally be where those 50 audits I mentioned earlier would be referred to us. We looked at those and we did raise various problems.

I believe this, though, that one of the problems we had in this whole effort—and we were trying to work on it in the last year or so—was that there was not enough visibility to the reports at the end. In other words, you are exactly right. Every Big 5 always received a clean opinion in the peer review. But there were letters of comments.

If you looked at those letters of comments, lots of times it was not as candid, it was not as plain English as to what some of the problems might be. We were trying to make progress there and we were not getting a lot of cooperation, to be very frank about it, and that was one of the things that discouraged the POB.

So, I think you have every right to say, why wasn't the current process working better?

One of the reasons why we are now recommending a new, much stronger oversight process is that we feel that the self-regulatory process set up in 1977 now needs to be significantly enhanced for the future.

Senator CORZINE. Thank you, Mr. Chairman.

Chairman SARBANES. Well, that does make an interesting point. It is very clear that there are tremendous pressure dynamics at work in this arena. Some of them come from the Congress, to be quite candid about it.

Mr. BOWSHER. Yes.

Chairman SARBANES. Much of it comes from the industry. Levitt tries to do something about all these nonaudit functions and everyone jumps all over the SEC. It doesn't happen. Of course, you could have said, they should have bulled their way on through with that.

Our challenge, I think, is to really try to get a system or a structure that, to the maximum extent possible—you cannot preclude it altogether—but that can check these kinds of pressures, so we get decisions made very much on the merits.

In that regard, let me ask you, Mr. Bowsher, could you again lay out for us concisely how your proposal for regulatory oversight of the accounting profession differs from the one that was put forward by the SEC and some elements of the profession back at the beginning of the year?

Mr. BOWSHER. Yes. If you look at our chart here, what the SEC would do is they would create a new board over the enforcement and the discipline part. That new board would be what I call a mixed board. It would have representatives of all the major firms, is the way that it was explained to us. So that would be five seats for the major firms, one seat for the AICPA. Then maybe seven seats for public members and then the chairman of the SEC said that the seven members would dominate the board.

Well, that is where we really differ because we think it would be very hard for those public members to dominate that kind of a mixed board. We had this experience with the ISB, which was put out of business at the end of 2 years. You really do need, I think, an independent board at the top of this.

Our board would be totally independent, as Aulana pointed out. We would have experienced people—accountants, lawyers, former SEC people—serving on that board. But we would not have any current partners of any of the major firms serving on that board.

Then what you literally have is we are bringing all the standard setting under the board, all the reviews, all the discipline, all the continuing education, whereas, his board would just only have a small fraction of these things, which would be the enforcement, the discipline, and whatever he's going to do with the annual review.

Chairman SARBANES. Let me ask this question because you move all the standard setting bodies under this new regulatory group that you propose. Is that essential? And in particular, does FASB need to be brought under? Or can FASB continue to operate in a somewhat separate status?

Mr. BOWSHER. You could leave FASB out to operate under their own board of trustees in that. But after giving it a lot of thought and consulting with a lot of people—former SEC chairmen, people who have served on the FAF, which I have myself, the trustees and others—we came to the conclusion that the fund-raising is not good, where you are passing that tin cup to people.

Chairman SARBANES. No, you would have to give them mandatory funding, I think.

Mr. BOWSHER. Okay. If you could do that, that would be good. But I think also the coordination with the other standard setting bodies is so important, that we would strongly recommend it come under this group.

You could do it the other way.

Chairman SARBANES. Provided they had the mandatory funding.

Mr. BOWSHER. If they could be brought in with the mandatory funding, that is right.

Chairman SARBANES. Okay.

Mr. BOWSHER. But at that point you do not need 16 trustees to serve on the FAF.

Chairman SARBANES. Jon, did you have something? We have this other panel, but go ahead.

Senator CORZINE. One more question. On rotation of auditors, the 7 year recommendation.

Mr. BOWSHER. Yes.

Senator CORZINE. If you were able to have this structure, my presumption is that you would believe that the discipline and the oversight of the auditing process and the activities, enforcement, discipline, would be stronger, enhanced by some significant degree from where we are today.

Mr. BOWSHER. That is correct.

Senator CORZINE. Did you then think about the cost of rotating auditors and the expertise that might be necessary to deal with the complexity that is truly involved with a lot of these companies and the set-up process?

Mr. BOWSHER. Yes. This is a debate that has gone on for many years. And that is, if you rotate auditors, do you give up expertise and therefore, have a great degree maybe of audit failure in that first year when the new audit firm comes in?

There has been some studies that kind of indicate maybe among the smaller audits that that is true. But when you look at the big audit failures of recent years, hardly any of them have ever been in the first year. In other words, if there is anything, it is that some corporations have been audited by the same firm for 15, 20, or 30 years. Some people say, maybe you need a fresh look every so many years.

I can assure you that right now, when all of these big auditing firms are picking up a lot of Arthur Andersen's big clients, none of them are going in there and saying, we are going to have any trouble doing this audit the first year. They are all in there saying, boy, we can do it and we will bring the expertise to make sure we can.

So, I have always thought that rotation brings the fresher look and the more independent look. Also, it forces the existing auditing firm to really want to do a good job here knowing that somebody else is going to take over.

When I was the Comptroller General, I encouraged support for a 5 year rotation in the "Yellow Book," which spells out auditing standards for Government. It has worked quite well. It works well up in Canada, too, where they have two auditing firms for the five big banks and they do some rotation up there.

So, again, I am really thinking of the bigger companies. John Biggs, who is one of our board members, and he does it for the TIAA–CREF, and insists on it, he is a strong believer, having lived with it now for several turn arounds.

Senator CORZINE. So your view is that, no matter how strong we put the cop on the corner that would not be adequate, in your view.

Mr. BOWSHER. I think the rotation would do more to improve the auditing within the firms and the decisionmaking in the firms, and that, ultimately, is more important than even the cop on the street.

Senator CORZINE. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Corzine.

I want to make one closing comment, looking into the future.

I think that not enough thought is being given to how we are going to interrelate with the International Accounting Standards Board.

If the European Union, as they have asserted, by 2005, adopts the standards of the International Accounting Standards Board, you will then have an economic entity as large as the United States, and potentially larger, as they add additional members and so forth. That is working off of one set of standards.

Mr. BOWSHER. Right.

Chairman SARBANES. I think that that will really sharpen the question in a global economy of how the U.S. interacts and integrates into that kind of environment.

So, we may be moving toward a situation where the old premise that whatever U.S. accounting standards were, those would be the accounting standards for the world, may not apply as it has tended to apply in the past. But that is kind of an aside.

Mr. BOWSHER. No, I think it is a very important issue that you raise in there because we were always hoping that we could get harmonization. Some people thought that meant Americanization.

We now know, especially after the Enron situation and a few other of our problem situations, that the overseas people are not going to automatically accept our principles.

Chairman SARBANES. We had Sir David Tweedie here from the International Accounting Standards as a witness at these hearings.

Mr. BOWSHER. Yes.

Chairman SARBANES. Thank you all very much. It has been extremely helpful and we look forward to consulting with you as we move ahead on this important issue.

Mr. BOWSHER. We would be pleased to do that, Mr. Chairman.

Chairman SARBANES. Thank you.

Ms. PETERS. Thank you, Mr. Chairman.

Mr. BOWSHER. Thank you.

Chairman SARBANES. If our next panel could come forward.

[Pause.]

Now, we will turn to our second panel. We are very pleased to have three able people here before us.

In our previous hearings, the issue of corporate governance has come up and we need to focus on that. In 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, put forth 10 recommendations to strengthen the independence, improve operations, and enhance accountability of the audit committee.

John Whitehead was the Co-Chairman of that Blue Ribbon Committee. We are very pleased that he is here with us today. Of course, we all know John very well. He was Deputy Secretary of State from 1985 to 1989. Before that, he was Co-Chairman and Senior Partner at Goldman Sachs, for many years. He is also a former Director and Chairman of the Securities Industry Association and a former Director of the New York Stock Exchange.

We are also very pleased to have Bill Seidman with us. Bill served as Chairman of the Federal Deposit Insurance Corporation from 1985 to 1991, and as Chairman of the Resolution Trust Corporation. Previously, he was Chairman of the accounting firm of Seidman & Seidman.

Bill, you might have been out of the room when Chuck Bowsher underscored the very significant contribution that you made to the FDIC reform bill in 1991. I think you had slipped out. And he un-

derscored what a terrific contribution it was to the public interest. I wanted to particularly acknowledge that.

Our third witness will be Michael Mayo, who is Managing Director of Prudential Securities and head of financial services research group. Previously, from 1997 to 2001, he directed the bank research group at Credit Suisse First Boston. And prior to that, he had a similar capacity with Lehman Brothers. He has been among the top three institutional investor all-star stock analysts for the past 5 years.

We should get that on the record. And we are interested in his being with us this morning because one of the areas that has been raised is the potential for conflicts of interest in the advice that stock analysts give to investors. Some very interesting questions have arisen over that very subject.

We are very pleased to have the panel here.

John, why don't we hear from you and then we will go to Bill and end up with Michael Mayo.

Senator Dodd, did you want to say anything?

COMMENTS OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman. I apologize for missing the first panel. I want to be on record thanking them, Chuck Bowsher and others.

There has been a lot of chatter recently about the effectiveness of the POB's and so forth. And whatever else we may decide on doing, I wouldn't want it to be any reflection of our lack of appreciation for the tremendous effort they have made.

I think Senator Corzine and I both feel that way. He may have said so in my absence.

Once again, it has been said here at almost every hearing, but these have been an excellent set of hearings. They are not as glitzy, I suppose, as some, where people are raising their right hand and walking out of the room. But if you want to really learn about what is going on and what are some of the best ideas and why other ideas may not be so great, these seven or eight hearings—I think this is the eighth hearing.

Chairman SARBANES. Eighth, yes.

Senator DODD. On this overall matter. It is about as thorough a discussion as has occurred here on the Hill. And that is all due to the Chairman, who has insisted that there be a deliberate, patient look at how we proceed.

Having a panel as distinguished as this one, I just want to join in welcoming John and Mr. Seidman as well, who I have had the privilege over the years of working with. It seems like old times to see both of you sitting there again to testify in these matters.

We thank you.

And thank you, Mr. Chairman.

Chairman SARBANES. I appreciate your kind comments about the hearing. But the proof of the pudding is in the eating, and we have not gotten there yet.

Senator DODD. We haven't gotten there yet.

Chairman SARBANES. But we look forward to getting there.

Senator DODD. But I think it is a good product that is going to emerge out of all of this. Thank you.

Chairman SARBANES. Let me just say, Bowsher and company gave us a very carefully worked out White Paper here that I think is going to be extremely helpful to the Committee.

Senator DODD. Good.

Chairman SARBANES. John, we would be happy to hear from you.

STATEMENT OF JOHN C. WHITEHEAD
FORMER CO-CHAIRMAN, GOLDMAN SACHS & CO.
FORMER DEPUTY SECRETARY OF STATE

Mr. WHITEHEAD. Thank you, Mr. Chairman, Senator Dodd, and Senator Corzine, nice to see you again.

I am honored to appear before you this morning as I have done a number of times in the past: First back in the early 1970's as Chairman of an SEC landmark study of the effect of institutional investors on securities markets, later as Chairman of the Securities Industry Association, and also as Co-Chairman of Goldman Sachs on various matters, and still later as Deputy Secretary of State and again on one occasion as Chairman of the Federal Reserve Bank of New York. I appear today, however, as a former nonmanagement director and former audit committee chairman of more than a dozen public companies, not all of them, I assure you, at the same time.

I have always championed the importance of our securities markets and the competitive structure of the institutions that serve them. They are a national asset and an important part of our leadership position in the world economy. The confidence that investors have in the system must be protected at all costs. I have also championed the importance of diligent, independent, nonmanagement directors who represent the stockholders effectively and also represent the public interest.

The Enron disaster is a severe blot on the generally good record that the system has had over the years.

Indeed, it is an embarrassment to those of us who have been involved in that system. It is still hard for me to believe that what was coming to be considered one of America's great companies could collapse so rapidly in such an ignominious way, with such huge losses to employees, to lenders, to stockholders, and to the reputations of everyone involved: The management, the board, the audit committee, the auditors, the bankers, the security analysts, and the customers. It would seem to me that grounds for criticism exist in many places and that a thorough public review and investigation, including these hearings, Mr. Chairman, is absolutely desirable and necessary.

I am knowledgeable enough about the system, however, to be quite confident that most companies act responsibly and that there are not a lot of Enrons out there.

The only good result of the collapse is that it is causing companies now to look closely at their practices and at their disclosure policies, causing boards to review their attitudes, causing auditors to be more independent and more thorough, lenders to be more careful, security analysts to be more thorough, and so on.

I can assure the Committee that there is now a self-cleansing process going on out there which is very healthy. It might be fruitful for the hearings to begin to focus not only on what actually hap-

pened to Enron, but on what the various institutions are doing now to keep it from happening again somewhere else. It may be wise to let this self-cleansing process go on for a while without being too precipitate with legislative action.

It is clear to me that there were many signs that a more alert or even a more curious board might have recognized as fair grounds for questioning. Certainly, any request to the board to waive the board's ethics rules to exempt a transaction that otherwise would have violated them should have been enough to bring a lot of questions. However, the Committee should realize that it is very difficult these days to find and successfully recruit good board members. Many top experienced executives who would make excellent nonmanagement directors feel that their hands are full handling their present job, that their lives are already too full of other responsibilities and that the doubtful prestige and relatively unimportant extra compensation from taking on one or two outside directorships is not worth the increasing legal risk and the necessary time commitment.

It would be a very unfortunate result of the Enron disaster if it became impossible now to recruit to board membership the kind of experienced, capable people that the system increasingly requires. The Committee should be careful about unnecessarily increasing the financial risks and the time commitments of nonmanagement corporate directors.

Having said that, I do believe some things can and should be done now, and I have five points to make.

Number one, having given the matter a lot of thought in recent years, particularly when I was Co-Chairman with Ira Millstein, who testified before you a few weeks ago, of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, I have reached the conclusion that the accounting firm that does the audit should not do other advisory work for the company. Without that, the independence of the auditor's work will always be suspect. I reach that decision reluctantly, but I don't see that it is possible now to restore public confidence in the independence of the auditors without it.

Now here is a point that is generally missed. The auditing firms should understand that this certainly does not require them to spin off or close down their advisory services. They would still be free to do advisory business with any company, excepting those they audit. Thus for any one firm what business they lose to others could be offset by business that others would lose to them, with no loss to the accounting advisory business as a whole.

As an alternative way of accomplishing the same purpose, it might be worth considering whether the restriction might be placed on the company rather than on the auditors by requiring that a public company should not employ their auditing firms for services other than the audit. It would be preferable if this all could be accomplished by SEC action or action of the exchanges rather than by legislation. Of course, it might be appropriate to provide for a reasonable phase-out period.

Number two, an unfortunate practice has developed in the relationships between management, auditors, and board audit committees on the setting of auditor's fees. Fees are set annually by nego-

tiation between management and the auditor and then approved by the audit committee. Management's objective, as it is with all expenses, is to keep the fees as low as possible. The auditor, at that stage, has no idea of how much time it will take, or how much extra work might be required, to complete the audit, and is often pressured to accept a lower fee and agree to a shorter time schedule than might be necessary in case questions arose.

Audit committees often agree to the fee and the time schedule, unwilling to question what seems reasonable in relation to last year's fee.

If the auditor later does find questionable practices, he may have neither time nor money to pursue them under the terms of his agreement. A better practice would be to allow the auditor, at his option, to do work and charge fees up to a limit of, say, twice the originally agreed fee. This would tend to make management more aware of the authority of an independent author.

Number three, over the years accounting rules, something like the income tax code, have become increasingly complex and arcane with the result that in combination they can often obfuscate the simple facts and obscure full disclosure.

Rules that permit these results, such as hiding off balance sheet debt, transactions with related parties, alternative accounting for acquisitions, and so on, evade the principle of full disclosure and undermine the foundation stone of our free market system. The National Accounting Standards Board should be asked to review these matters promptly and recommend appropriate changes in the interest of full disclosure.

Number four, rules now require that the chairman of a public company's audit committee have considerable financial background and experience. Those rules should be amended to require all members of the audit committee to have such backgrounds. This will encourage the recruitment to the board of more experienced and qualified people and recruitment to the audit committee those with the most financial experience.

Finally, number five, since the principal purpose of audits is to provide public information to investors and the financial community, I believe the self-regulating authority of the SEC over the securities industry and the stock exchanges should be extended to the auditing firms. This would be an important addition to the present self-inspection system of the auditing companies. I know the earlier panel discussed that at some length. The authority of the SEC should also be extended to create a new self-regulatory entity charged with drafting a voluntary code of best corporate governance practices linked to an SEC disclosure requirement. Companies would then disclose whether they comply with the voluntary code, and if they do not, explain their areas of noncompliance and their reasons for not complying.

I believe that these recommendations would be important moves forward.

Thank you very much, Mr. Chairman.

Chairman SARBANES. Thank you. That was very, very helpful.

Mr. Seidman.

STATEMENT OF L. WILLIAM SEIDMAN
FORMER CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
FORMER CHAIRMAN
RESOLUTION TRUST CORPORATION

Mr. SEIDMAN. Thank you very much, Mr. Chairman, and Senators. It is nice to be back again. It is a great honor to be on with John Whitehead, Mike Mayo, and to listen to Chuck Bowsher's excellent remarks.

I have listed here a few reasons and my background why I might have some relevance to what went on in Enron, including the fact that I headed an accounting firm in troubled times, as a matter of fact, with the problems of equity funding.

So, I have some feel for how an accounting firm——

Chairman SARBANES. We go looking for you every time there is trouble, Bill, to help us out of it.

[Laughter.]

Mr. SEIDMAN. It looks like it. Anyway, I was also here when the banking problems went on. So, I will pass that over and get to my comments. My comments cover the range of the subjects that you have been discussing.

One of the first things that I would note is that the Enron failure has caused tremendous losses. And we have heard a lot about it. But as far as I know, we have never heard exactly what happened. We do not really know what Arthur Andersen did, what it said, why it audited the way it did. They said they were studying that, but we are a long way from knowing what happened at Enron.

So what I am saying after this is my surmise of what happened based on what we know now, knowing that Anderson has never testified. And my first comment is that this was essentially an accounting failure. Mr. Skilling made that very clear every time he was asked what happened. He said, I depended on my auditors, and that is usually a pretty good defense.

I think that what we found, as far as what we know now, is that Enron held itself out to be a trading company. As Mr. Skilling said, if I bought on one side, I sold on the other side. So if somebody told me there was a big loss here, I wasn't worried because I had an offsetting thing.

The first thing you look at when you audit a trading company is how much market risk they take. Most trading companies mark-to-market, as the Senator knows, every night, so they know exactly how much trading risk they are taking. Auditing such a company, that would normally be the first thing that you would look at.

We now know that Enron really was not a trading company. It was a speculating company, speculating on volatile markets. And when the markets went against them, they failed. Why weren't they a trading company? Because they were hedging with their own related companies for which they were ultimately financially responsible. Once they used up the capital in those related companies, it came down to them to make up for the losses. So, in fact, they were not what they held themselves out to the world to be, and they were not, I guess, what most of the directors thought they were, which was a trading company in energy and the other new fields.

And how Andersen arrived at the conclusions that they did, that they were fairly presenting the financial statements, given that, is something, as far as I know, we haven't heard from Andersen on. I cannot go further than just say, what we have so far, it seems to me, to say that this is an accounting failure based on a misperception of what the company was actually doing.

I could be proved to be all wrong on that if they come in and explain it. But from what we know now, I think that is a reasonable explanation of what went on.

As part of this, they mark-to-market contracts under the new hedging rules and derivatives rules where there really was no market. And therefore, Enron, as the prime market-maker, stated what the market was, maybe electricity prices over the next 10 years, marked-to-market, and then took a profit on the contracts because, in their view of the market, this was a profitable contract.

There are some very important issues that I think have to be analyzed to have reasonable recommendations on what might be done here.

Therefore, the first thing is how about the accountants and the auditing and accounting principles that were used at Enron?

I heard Mr. Bowsher's testimony. I would generally subscribe to it, with a couple of exceptions which I will note. So, I will depart from what I had here because it might be more useful to you.

I would say to begin with, CPA's are different. They are hired to audit a firm which pays them. They have a fundamental conflict of interest going in, like no other profession has, because they are examining a company which is, in effect, paying them to find out whether they are honest or not and also whether they are fairly presented.

In that kind of a situation, I think that you have to have very substantial Government control. I do not believe that the kind of thing that we have had so far has worked. I did not think it worked when I was in the profession. Therefore, in looking at Mr. Bowsher's suggestions, the real question to me is, should that board be an independent board, appointed by the President, confirmed by the Senate, like we do for banking, like we do for other things that are fundamental to our economic system?

I think accounting is clearly fundamental to a basic free market capitalistic system. So, I would raise that question. Then the second question that follows from that is, what is the relationship between that and the SEC?

The only thing I have in my experience is what we did with the RTC. If you remember what the Senate did, we had one body that set policy and another body that carried it out with the individual companies involved. And there might be some guidance in that kind of a thing, where the SEC would deal totally with companies and reports and so forth, but the profession would handled by a separate body.

Other than that, I subscribe to Mr. Bowsher's recommendations that the three units be put under one board so that they can be coordinated and that they be charged with accounting principles, auditing principles, and discipline and regulation.

In that regard, I agree with that. The only thing I would say about the swinging door or the auditors that go to clients, I think

that has been discussed for many years. Whether or not we ought to do that or not, the only concern I have about it is that it will make it much harder to hire young people to go into accounting because they find the swinging doors generally a large part of the attraction to accounting. But that can be weighed against the benefits that you see.

I agree that, clearly, you have to have independent sources of funding for those things, so that we do not get into the kind of problems we had before. I would also say that we need to provide that board with the best possible protection we can against influences, both private and public.

When I was at the FDIC, we had some very effective rules to protect us, to some extent, from both the private, and we even passed a rule which probably most of you do not remember, that if public officials came to influence us with respect to any particular client, that we had to publish that visit promptly after. And we did not have many visits after that.

With respect to corporate governance, Enron raises some very interesting questions because, is the defense that I relied upon my accountant and my lawyer, to say that this was all appropriate, really all we can expect from directors?

I subscribe to John's view that we have to be very careful not to put such burdens, unrealistic burdens, on directors that we won't get any competent directors. And I think that is doubly true with the audit committees.

Very frankly, I am on a bunch of boards. I always try to keep off of the audit committee because, as a CPA, the standard for me will be so high, as to be very dangerous. And I haven't succeeded, incidentally.

[Laughter.]

But I think that that is an important point that has to be taken into consideration.

So, in looking at this, was there a real failure on the part of the Enron board? Well, clearly, it was inappropriate to approve this conflict of interest between the related companies. Yet, if you look at what they did, they had a very detailed procedure for doing it. They had given different people that were supposed to sign off, and so on, and it was not done haphazardly.

I really find it difficult at this point, not knowing more about what Andersen told them, to say that the board acted totally inappropriately, or can I think of any particular thing from Enron that might be suggested?

I have two suggestions on that.

First is that, in my experience on a lot of boards, having the chairman of the board and the CEO be the same person works many times. But when it doesn't work, it is a disaster. When you get real power like that in one person, and there is no real way to deal with it, it can be very expensive. This may have been true with regard to Enron. Mr. Lay was obviously the soul of the company. That is one thing.

The second thing is, and I think it really goes along with your recommendations, that the committee that elects members to the board should be an independent committee, and that the CEO of

the company should not be on that committee, because if you do not have that, then you really can get into the crony system.

I will just close with two things regarding Government regulation, which I think is the third area that this raises. It raises the area of the auditors. It raises the area of the corporate governance and it raises the area of Government regulation.

Clearly, Enron was operating in an area where they tried very hard to keep the Government from supervising it. They made no bones about the fact. And the argument and the idea was that the market will be much better if it is ruled by the discipline of the marketplace, therefore many of these new things that they were developing trading for should not have any market supervision.

It seems to me that this experience does not support the idea that this is any different than other futures markets and so forth. And the question is, what kind of supervision or laws can you have, particularly in these very complicated areas?

This, it seems to me, more than anything, would be an area where disclosure would be the best remedy to begin with, and full disclosure. For instance, one of the first things that ought to be disclosed, and this is now being discussed with Fannie and Freddie, is: "Who is your counterpart on hedges? Is your counterpart viable under the kind of potential hedging liability, involved?"

That, after all, everyone says, well, we have this nice market where they hedge. But if the hedge is not any good—ask the people who had Russian banks for hedges when they collapsed. That took several very good firms out of business.

So who are they hedging with and what disclosure can we get as to the hedge capability of handling these things, and there may be other things.

Obviously, that would be something that ought to be put into the hands of a commission. I do not think you can legislate in detail on that. But the responsibility ought to be put in the hands of the commission.

I will finally say, and I am not even sure that this is in your area, but I think if you look at Enron and see that they paid no taxes in several years when they were reporting hundreds of millions of dollars of income, it indicates that we have a huge gap in our taxation system right now. From my personal experience, it is getting worse. My experience around the world is that when you do not collect taxes effectively, it jeopardizes the whole system of Government. I think that is an area that should be looked at and examine what Enron did with Camen Island things and all the rest. But I think that is a real threat to the operation of the system we all want.

I will end just like John did, by saying the danger here may be in doing too much rather than too little. But there is certainly a danger if you do not do something.

I appreciate your attention. Thank you.

Chairman SARBANES. Thank you very much. It is very helpful.

Senator DODD. Mr. Chairman.

Chairman SARBANES. Yes.

Senator DODD. I want to apologize to Mr. Mayo. I unfortunately cannot stay for the rest of the hearing. But I wanted to indicate

my gratitude to all of you and tell you how important your testimony is.

I am just curious. Again, reading newspaper stories about this, but I read one story where, allegedly, the audit committee at Enron never asked to meet with the accountants, even when these problems began to unfold.

Like you said, this is an accounting story and I think it certainly is to a large extent based on what we know. It is also an Enron story here that we do not know much about.

Mr. SEIDMAN. Yes.

Senator DODD. We have relied on a couple of witnesses who have told their side of the story. But as more comes out, I think you are going to find that maybe passing the buck certainly has some legitimacy, but you cannot pass all the bucks over.

Mr. SEIDMAN. Those are the kinds of things we do not know at this point.

Senator DODD. Last, I would just mention this to the Chairman. I meant to bring it to him the other day. But there was a piece in *The New York Times* which indicated that where the IRS audits are occurring, there are stunning numbers about the massive increase in audits of people at the lower income levels in this country and the significant decline in audits of people at the upper income levels in the last 5 or 6 or 7 years.

Mr. SEIDMAN. It has gotten so complicated—I would do, if I were there, what I did when I was at the FDIC. I would hire the big law firms and accounting firms to represent the Government in policing some of these very complicated and sophisticated areas.

Senator DODD. Thank you all.

Senator Corzine and I have written a proposal for the Committee to consider. A lot of it deals with the very subject matters you have discussed and I presume that Mr. Mayo will discuss as well. We certainly invite your comments on what we have put down on paper and I will let Jon raise those issues with you.

I apologize.

Chairman SARBANES. It is all right. No problem.

Mr. Mayo, we would be happy to hear from you.

STATEMENT OF MICHAEL MAYO MANAGING DIRECTOR, PRUDENTIAL SECURITIES, INC.

Mr. MAYO. Chairman Sarbanes, Senator Gramm, and Members of the Committee, thank you for inviting me to testify today about conflicts on Wall Street. I will cover conflicts among brokerage firms, corporations, and research analysts. I currently work for Prudential Securities, which values independent research, however, I am here today to give my own personal point of view.

It is great to be back near my home in Maryland. I hope that the University of Maryland basketball team advances far in the NCAA basketball tournament. I can guess that the Chairman shares my hopes.

Chairman SARBANES. That is a fair guess.

[Laughter.]

Mr. MAYO. I am here to talk about what can be analogous to playing basketball with one hand behind your back. Objective analysts, those with negative opinions and/or critical remarks, may

have trouble holding corporations accountable. The reason is that companies themselves and their managements are the best source of information, and bullish and conflicted analysts may have the best access to this information.

It is still hard for an analyst to be objective and critical. When an analyst says "sell," there can be backlash from investors who own the stock, from the company being scrutinized, and even from individuals inside the analyst's firm. While much attention in Washington is being paid to the pressures related to a firm's investment banking operations, other pressures can be as great or more. The main point: Some companies may intimidate analysts into being bullish. Those who stand up may face less access to company information and perhaps backlashes, too.

I have a few perspectives to support my view—From personal experience: I have worked at 4 of the 10 largest brokerage firms. I understand how the brokerage industry works. From my research: I have covered the banking industry since the late 1980's and head the financial research group at Prudential Securities. From my stock ratings: When the facts support it, I do not shy away from placing sell ratings on companies I cover. I have probably done so more than almost any other analyst. And from my current firm, Prudential Securities: A year ago, Prudential shed almost all of its investment banking activities.

I will cover three areas in my testimony today: One, my personal experiences. Two, the conflict between serving investors versus corporations. And three, problems with access by research analysts to corporations.

Number one, my personal experiences.

As I prepared for my career, I had all the usual training—financial textbooks, MBA training, professional certification, and even training at the Federal Reserve here in Washington. But playing-by-the-book does not do it on Wall Street. Here are a few personal examples to illustrate my point.

First, after publishing a report with a hold rating—not a sell but a hold rating—the CFO of the subject company had a shouting match with my boss and me. There was a threat of investment banking business getting withdrawn. Luckily, my senior management supported me.

Second, I published a report criticizing a merger. One investment banker barked at me, "How do we make money off this research?" I stuck with my opinion.

Third, a bank excluded me from an important dinner meeting at which all of the other banking analysts from major firms were in attendance.

Fourth, a CEO called to complain. He did not like negative comments in a report. He said that he gave investment banking business to my firm due solely to me. He said we had "let him down." I said simply that we are objective with our analysis.

Fifth, I placed a sell rating on one bank. I was told that the bank's management, in turn, told large investors that we had not done our homework, effectively criticizing our research approach. Within 6 months, I was proven correct after the stock declined as a result of issues with earnings.

Sixth, we asked to visit with the management of a company. The response was, "No." I finally took a meeting with one company representative. They had said, "Take it or leave it." What choice did I have?

So whether the time was the start of the last decade or the start of this decade, whether the firm was UBS, Lehman, Credit Suisse First Boston, or Prudential Securities, the backlash from corporations was similar. Little has changed to help me perform my job better. This pervasiveness suggests there are larger issues at work. We need to address these issues to ensure that investors get unbiased research.

Number two is the conflicts at brokerage firms: between serving investors versus corporations.

This statistic is critical: The brokerage industry earns four times as much from serving corporations, for example, through investment banking and related services, as from serving investors. Two decades ago, in 1982, this ratio was one to one. In addition, the same firms—the 10 largest brokerage firms—that get most of the trading business with investors gain an even greater percentage business of investment banking activities with corporations.

So who is really the client? The degree of conflict between serving corporations and investors—based on where the money is made—is at its highest level in history. If nothing else, this creates an environment ripe for abuse.

For brokerage firms, what does it mean to earn four times more from corporations? First, investment bankers have the leverage. They want research analysts to act as team players. To them, this may mean saying nice things about their major corporate client or potential future clients. Second, brokerage firms hire people who get along with investment bankers. One manager who hired me said that, in evaluating analysts, the firm placed a lot of weight on what the companies had to say to investment bankers. Can you imagine? This is like judging a food critic based on what the restaurants say.

For analysts, what does it mean that their firms earn four times more from corporations? It means financial incentives, which can taint analysts' opinions, and keeping a job. It is not rocket science: 80 percent of traditional brokerage profits come from corporations. Help the firm, you do well. Hurt the firm, why get rewarded? Analysts are mainly bullish and conflicted, probably because they do not want to lose their jobs.

My main point: People do what they are incented to do. For brokerage firms, the incentive to serve corporations over investors is stronger than at any point in history. For analysts, the main incentive is to stay employed.

Number three is the problems with access by research analysts to corporations.

It takes an objective and critical analyst many times more work to do the job than it does a bullish or conflicted analyst. The main reason: Backlash from corporations. Such backlash can take various forms. I have five examples:

First, investment banking: The influence of investment banking on stock research is well documented after the Internet bubble. Per

my other examples, sometimes companies pull business from a company after a critical report.

Second, phone calls with the company: Phone contact is part of an analysts' day-to-day communication to get more color behind the numbers. Bullish and conflicted analysts can get their calls returned first, and even get senior executives on the line, including the CEO. As for objective and critical analysts, at times their calls are not even returned.

Third, meetings with the management: Some firms reply to a meeting request, "Why is it a good use of our management's time?" In other words, "Say something positive, we will let you in."

Fourth, conference calls: Companies hold conference calls for earnings, strategic moves, and other reasons. Conference call systems let you manipulate the order that questions are answered. Last year, on one call, the operator said that my call was in the queue. I then hear, "No more questions." Do the more novice investors listening to the conference calls realize that the order of the questions can be manipulated?

Fifth, managements participation in analyst events: Institutional investors—my main clients—pay a lot of commissions if you hold good conferences and bring managements in to see them. Guess who gets to do these tasks? Bullish and conflicted analysts, especially those whose firms have investment banking relationships.

For the bullish or conflicted analyst, calls may be returned first, questions may be taken on conference calls, meetings with management may get scheduled earlier, managements help out to visit investors or participate in conferences, and investment banking fees may be better to boot.

Reg FD has not fixed all of the problems. Companies simply make canned presentations on a webcast, but then may choose to turn off the webcast during the Q&A and the follow-on breakout sessions. Also, some firms do not webcast their presentations, which I find very discouraging.

Perversely, this poor treatment has helped to make me and my team better analysts. We are forced to better scrutinize accounting footnotes, interact more with impartial third parties, and go out and "kick the tires."

In other words, we are forced to hustle a lot more. To use the analogy, we are still doing the equivalent of playing basketball with one hand behind our back. The issue: I am not sure how many analysts are willing to accept this handicap, especially the newer ones trying to pay their New York City rents.

To recap the problems: First, from my perspective, it is business as usual when it comes to conflicts between companies and their research analysts. Second, people do what they are incented to do. The financial incentives for brokerage firms to serve corporations has never been as high as they are today. Third, objective or critical analysts continue to face backlashes in many ways.

So what is the solution—information and incentives. From my perspective, speaking solely as an independent analyst, there are a few steps that can be taken to improve the situation:

First, information: Make sure that the access to the information is fair. One idea is have an avenue for those analysts who feel disadvantaged by the companies they cover to voice concerns and get

corrective action. Maybe a clearinghouse whereby analysts have recourse to voice their concerns. Maybe someone at the SEC. Just give me someone whom I can call when I am treated unfairly. One caveat: Any solution needs to ensure that companies still are incented to maintain the highest level of information flow. I do not believe we need to regulate analysts. Analysts need to have equal access to information and appropriate incentives to provide objective research. Let's address the root of the problem.

Second, incentives: Take actions to minimize the interference of investment bankers with the job of research analysts. Disclose investment banking relationships to investors. Does the retail investor know that the brokerage firm pitching shares is also earning investment banking fees from the company? A related solution is to eliminate deal-based incentive pay. Also, in terms of carrots and sticks, a lot of attention has focused on making the stick bigger to get the so-called "bad" analyst. The "carrot" needs more attention, to encourage good behavior. I know there is debate about separating research from investment banking. From my personal experience, I can tell you that this is an effective solution.

My conclusion is that we have the best capital markets in the world. But let's not grade ourselves on the curve. They can be better. As analysts, we are at the intersection between the interests of corporations and the interests of investors. We provide institutional memory, act skeptically, challenge corporate authority, question assumptions, and speak up if something does not smell right. We are on the front lines of holding corporations accountable. Prudential Securities scaled back its investment banking a year ago. The result is a great environment for me. I have 100 percent support of my management when I am doing my research. Despite this, the pressures outside the firm are as strong as ever. The result: Impediments to conducting full, independent, unbiased investment research on corporations. Action that can help remove these impediments and reduce the remaining conflicts will help improve our ability to serve clients, and when I talk about clients, I am talking about investors.

Chairman SARBANES. Good. Thank you very much, sir. Very interesting testimony.

John, in your statement, you say, and I am quoting you now: "The authority of the SEC should be extended to create a new self-regulatory entity charged with drafting a voluntary code of best corporate governance practices linked to an SEC disclosure requirement. Companies would then disclose whether they comply with the voluntary code and explain areas of noncompliance." Could you develop that a little bit for us, please?

Mr. WHITEHEAD. Yes. I am a big fan of codes of conduct that are not legally required rules, but are considered by people in industry who have high standards to be rules that everybody should comply with. Let me think of an example.

I believe the New York Stock Exchange rules require that a public company must have at least two outside directors. It would seem to me that that is appropriate when a company is first going public and let's say a family ownership company goes public and the public shares now represent 10 percent of the total shares.

As that company goes public more and more, it seems to me it can be argued that the percentage of outside directors should increase as time goes on, and that if 90 percent of the company is owned by the public, there should then be very few inside directors or management directors.

I think a code of conduct might say that the percentage of outside directors should be roughly proportionate to the percentage of stock owned by the public. But to make that into a law, or even an SEC rule, would be difficult. This would be an example of what might be part of a code of conduct. If the company still only had two outside directors and 90 percent of its stock was owned by the public, it would be required in its proxy statement each year to say, the company only has two outside directors. Yet, 90 percent of our stock is owned by the public. And the reasons that we have that is such and such.

If the reasons looked weak and rather silly or self-serving, I think they would be under great pressure to change them because it would be pointed out that this is a ridiculous situation that they would have to disclose.

That is an example. There could be many other examples, including some in the areas that the last witness was describing, which a code of conduct, a code of high standards, would help solve.

Chairman SARBANES. Thank you very much.

Mr. Mayo, how much of this can we get at by just disclosure? Suppose the analysts had to lay out their companies' connections with the corporation that was being rated, their own personal connections—whether they hold the stock, et cetera. How much of a difference can that make?

Mr. MAYO. I think disclosure makes a big difference. However, there is always the implied threat. If you are getting 80 percent of your traditional brokerage profits from investment banking, then there is always the understanding by the analyst—again, it is not rocket science—that if you make money for the firm, you will do well. If you do not, then you might not do as well.

And so, disclosure goes to a certain point. But from the analyst's perspective, I think there is still an issue about the implied threat by investment banking on an analyst's ability to have complete freedom and show unbiased research.

Chairman SARBANES. Well, I am struggling on how to deal with it. Bill Seidman did not read this paragraph and I am going to read it because I think it is quite a good paragraph.

Mr. SEIDMAN. Thank you.

Chairman SARBANES. He said, "A good free market operates like a 'prize fight,' plenty of chance to slug it out, but not below the waist and not with the second's stool. An unrestricted market is like a 'ballroom brawl' where the fight results in widespread destruction of both people and the place, and the winner may be the dirtiest fighter on the scene.

"The trick, of course, is to have the right rules that promote fair competition without stopping the competition."

I think that is very well put. It doesn't give me an answer, but it is a nice frame of reference with which to go at this thing.

Mr. SEIDMAN. Thank you.

Chairman SARBANES. You then go on to talk about Enron being in an unregulated environment, at least for a good part of their activities, and the consequences of that, and I think that is a point well taken.

We are trying hard to boost the budget of the SEC right now. I have for years felt that they were underfunded. Senator Corzine has taken a keen interest in that issue as well. We want to give them pay parity. In fact, we thought we had reached an understanding that they would get pay parity, and to our great surprise, the Administration did not deliver that in the budget, although they did move ahead and reduce the fees and that was all part of a package.

Do you perceive the SEC as being significantly underfunded in terms of its ability to carry out its functions?

I ask any one of you.

Mr. SEIDMAN. Yes, I do. I think it definitely is underfunded. I think Chairman Levitt made that point, the present Chairman. And all along here, as I suggested to the IRS, the ability of the Government to take on the astute private sector in these areas is falling behind, and I think it definitely needs more funding.

Chairman SARBANES. Well, you feel that, in a sense, we are slipping so much, that even the IRS lacks the expertise that it needs to handle some of its challenges and therefore, it should be thinking of contracting with the private sector to do it. Is that correct?

Mr. SEIDMAN. I think that is correct. That is what I did at the FDIC. When we were suing Mr. Milken, he had four huge law firms on his side and we had our GS–15's. I thought it was an unfair contest. So, we hired a major New York law firm to represent the FDIC. Now the Justice Department has done that in the Microsoft case. And I think it is very effective for the Government and it is in a way low cost because you just hire them for the job. I think it would be something that they should have a budget for.

Chairman SARBANES. Interesting suggestion.

John.

Mr. WHITEHEAD. Yes, I agree with all of that. I think the SEC is underfunded and has been for some years. When you consider the seriousness of the system of just one Enron, it is dangerous to fool around with relatively small increases in budgets that the SEC asks for.

Chairman SARBANES. Right. Do you have any observations on that, Mr. Mayo?

Mr. MAYO. I haven't studied it, but my one observation is to look at the SEC budget relative to the stock market capitalization. I believe that percentage has gone down for the past few decades.

Chairman SARBANES. My time has expired.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Let me note that I have been sitting erect and firmly in my chair listening quite securely since I have one of my own former chairmen here who brought me through my training process at my old firm—I do not know whether he thinks successfully.

Chairman SARBANES. Well, we think successfully. We think you did a terrific job.

[Laughter.]

Senator CORZINE. Let me give a great compliment to John Whitehead because, as a youngster growing up in the securities business, I was just constantly challenged with the elements of greed associated with the business, some of which you have heard Mr. Mayo talk about.

John wrote a business principles issue which I think goes to the code of conduct that he probably is offering in the back of his mind. One of those codes was, our assets are people, capital and reputation, and if any of these is ever diminished, the last is the most difficult to restore.

We had real leadership on this. And while I think there is room for regulatory and maybe even legislative response, ultimately, the leaders of corporations, leaders of business, need to establish standards that operate in the cultural milieu that we are all about.

We heard some of that reflected in Mr. Mayo's comments. I can only say that John Whitehead is one who has practiced what he preaches in an extraordinary way throughout his career. It is always hard for me to ever disagree with him, although, on occasion, we have. And I do not in this particular instance. But I did want to make that comment with regard to his contributions.

Let me turn to one of the specific questions, and I would be interested in any and all of you to comment on. But it gets at what Mr. Seidman had talked about in contracting out difficult assignments. I think it relates to one of the questions that is very hard for me to sort out. And this is the rotation of auditors on a 7 year basis, 5 year basis.

The logic of it is it has merits. This is one of those tough pros and con balancing issues to me. But it strikes me, as we get more and more complicated, as you were just suggesting with regard to the nature of looking at these institutions, that we might gain greater security through the cop on the corner as opposed to the rotation device. And given your great wealth of experiences, I would love to hear your comments on it.

Mr. WHITEHEAD. Shall I start, or do you want to start?

Mr. SEIDMAN. Go ahead.

Mr. WHITEHEAD. I am not sure I am right on this thing. Some things I am sure I am right. I do thank you for your kind comments and the respect I have for you and your own career.

I do not agree with many of your political views, but I do agree with you on this general subject of corporate responsibility and ethical conduct. And you carried on traditions at Goldman Sachs in your era that made me very proud.

I guess I reached the conclusion that some kind of compulsory term for outside auditors is probably a good thing. There are pros and cons of it and the Chairman described those in earlier questions. It shouldn't be too short a term because there is advantage in somebody who knows the ropes, who knows the companies, who knows the problems, and has worked on the audit for some years. But then, if it goes on for 20 years and it is still the same people and they still have the same close relationships within the company, it is hard to think that that auditing firm might have the same courage to stand up and disagree with something that they disagreed with.

I would say somewhere in the 8 to 10 year period might be striking, in my mind, about the right balance when the accounting firm should really change and when it is better to bring in a new firm, a new organization that would take a new look at the company.

So that is about where I come out. I think that would be a good idea. I do not know what is necessary to institute that, whether the SEC has the authority or whether the stock exchanges have the authority to do that. I do not know. But it seems to me that would be a wise compromise between the two extremes.

Mr. SEIDMAN. Well, I thought John was going to say that the code of conduct would handle that by simply saying the preferred code would be, and if you do not change for so many years, you ought to explain why and so forth.

I think this idea was first put forward by my former Senior Partner, Jack Seidman, when he was head of the AICPA. And it brought down a torrent of abuse on his head, particularly since he wasn't head of one of the largest accounting firms. So it was a very contentious issue and has continued to be.

Looking at it, now that I have been out of accounting a long time and at the companies that I have been with, I think if we did have a code of conduct and it said that this was the preferred method, that might be as effective as anything.

My fear, in changing the accountants, is that competition among accountants is terrific now. And if they know that every 5 or 6 years, they have to go out and compete for new ones because they are going to lose the old ones, it is going to make it even worse than it is.

So, I have some reservations about that kind of a mandatory thing because, again, the competition in a place where you are competing so that you can then go in and look at the company that has finally chosen you and see if there is anything wrong with them, is a very difficult situation. I would rely more on the regulatory structure, I think.

Senator CORZINE. I have one more question for Mr. Mayo, and then I have to leave.

You outlined a number of the conflicts which I think investment banking firms and securities firms deal with on a day-to-day basis. I am sure Mr. Whitehead had many of the same experiences in trying to sort out relationships and independence of analysts that I know that I experienced in my career. Some of those yelling matches that you may have had with CEO's actually came to chairmen's offices and it is the responsibility of the chairmen to insulate and protect their analysts in those cases.

One of the conflicts you did not talk about is the investment activity of the analysts themselves, whether they hold stocks, whether they trade stocks, whether they are involved in the companies themselves that they are involved in. I was curious why that was left out, or do you think it is not a problem?

Mr. MAYO. If I had $100 to spend on a solution, I would spend $1 on the issue of stock ownership and the other $99 on the other issues. There has been some egregious cases reported in the press, aside from that. I did not know it was a big issue until the past few months, except for the real egregious cases.

I think that misses the bigger issue of lack of equal access to information by analysts and the inappropriate incentives either on the upside, but especially on the downside, and I think that is the story that has been missed. I will spend $99 working on that solution relative to the stock ownership solution.

Senator CORZINE. All right. There are serious questions of incentives that I think can flow from involvement in these things. And disclosure may very well be one of those responses you have there, as well as compensation packages which are indirectly the kind of thing that I think reflects a stake-holding in the underlying company that is analyzed.

But those are things that we need to talk about and the code of conduct I think is absolutely essential with regard to straightening out some of the public's lack of confidence in the industry's independence with regard to its analysis.

It is really separate sometimes from the accounting issue, but one that can be handled with listing standards or the SEC or the whole set of different rules.

Thank you, Mr. Chairman.

Chairman SARBANES. Thanks, Jon.

Senator CORZINE. It is good to see you, and I thank the witnesses both for their presentation today, and for their public service throughout. It is an honor to be here and hear your remarks today.

Chairman SARBANES. I want to ask a question of Mr. Seidman. You have had a very distinguished both private and public career and have certainly fought for the public interest in your public jobs.

We read about these so-called giants of the accounting industry or profession. I am not quite sure which term to use in the circumstance. We talked about high standards and financial rectitude and so forth. Has something really gone wrong? Is there some underlying thing that we are not identifying that has helped to create this problem? Or is it just in every barrel of apples, there is going to be some bad apples?

Mr. SEIDMAN. Thank you, Mr. Chairman. That is a hard question to answer. I think what has probably brought us to the kind of problems we are in now is the increasing complexity of the business world, the increasing concentration in the accounting profession until there are a very large mass of groups and the leadership is more a manager, maybe, than he is an accountant, or at least he's outstanding because he is a manager.

So, I think my view is that human nature hasn't changed. There are still leaders around. But because of the complexity of the world that has developed and because of the concentration, it is much harder for them to emerge and provide that kind of leadership.

Chairman SARBANES. I take it, given that complexity from the close of your statement, we really need to have some Government role that provides at least the framework or the structure within which these activities take place and that can at least give us some assurance that the more egregious forms of conduct will be blocked out or ruled out.

One perception I have is, unless you do that, you run the risk that the practices will go to the lowest common denominator because the people engaged in those practices, if they can do it without being called to account, may in fact gain what they perceive is

a competitive advantage, or put others, what they would see as being at a competitive disadvantage.

They may not want to do that practice. They may not think it is the right practice to do. But it is being done and those doing it are gaining advantage from it.

It seems to me that we somehow have to get a structure here that—and the code of conduct I think becomes relevant to that consideration as well. Do you perceive it that way?

Mr. SEIDMAN. I do, Mr. Chairman. I think you read that little statement that I made about the fight.

Chairman SARBANES. Yes.

Mr. SEIDMAN. You need a structure and that structure, particularly in accounting because accounting, per se, is a conflict of interest. Therefore, you have to have a Government set-up structure within which they perform.

I am sure that when I was heading an accounting firm, I would not have said that. But having been out of it a little while and looked at it from more of a business view, I think it is something that is going to be necessary.

I think we have given the self-regulatory system all the chance in the world to operate and Enron proves that it is not effective.

Chairman SARBANES. John, let me ask you, it seems clear to me that we have to have a mandatory source of funding for whatever board we have, or boards, that set the standards, do the enforcement, and so forth.

This going around with a tin cup and begging contributions from the very people that are being regulated obviously doesn't work. They would give the money to the Public Oversight Board, for example. What is the best way or place to get that source of funding?

Mr. WHITEHEAD. I am not one who generally supports increased Government funding. But I do in this case. I think those kinds of things should be financed from the SEC's budget or as part of the SEC's budget, with public funds. They are expended to help the public, to help the public investor. And it seems to me that it is not a bit unfair that the public should share in the cost of those basically regulatory policing organizations.

Chairman SARBANES. I agree with that, except that we then run into the perils of the appropriations process. We have been trying to think of putting a fee somewhere. Either the listed companies would pay some kind of fee or maybe the accounting firms would pay some kind of fee. Do you have any thought on that?

Mr. SEIDMAN. I would make it a fee for all the listed firms. In other words, it is a cost of being listed that they would pay a certain amount.

Chairman SARBANES. That would then fund these organizations.

Mr. SEIDMAN. And I would fund these organizations.

Chairman SARBANES. Do you have a problem with that, John?

Mr. WHITEHEAD. Well, there are a lot of others that benefit from them, too. All investors benefit. Maybe the large institutional investors should pay their share. The brokerage firms, investment bankers all benefit from the success of the system and the volume of investment that flows through them.

So it seems to me that it gets back to being the whole public benefits from our wonderful capital markets and people's capitalism system. Actually, public financing doesn't disturb me.

Mr. SEIDMAN. What disturbs me is you are part of the appropriations process.

Chairman SARBANES. We just discussed the difficulty of getting the SEC an adequate budget to do what they are now charged with and are falling short of that. This would then require us to go even further.

Now, you can get that budget, perhaps, we are trying hard now, in this particular climate right now. But how long that will last and whether it will survive subsequent budget rounds once you hopefully get the issue back in a more normal perspective, is an open question.

Mr. WHITEHEAD. I think the Enron disaster gives you a lot of ammunition that maybe you did not have a few months ago, and that there is nothing wrong with using that as a strong argument to not take away power from the SEC at this particular moment.

Chairman SARBANES. We have been joined by Senator Carper. I yield to Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman. And to each of you welcome. It is great to see you all again and thank you for joining us.

I have been at a couple of other hearings going on and I am just glad you are still here and I was able to join you for a couple of minutes.

Can we stay with the issue of how to pay, how to raise the revenue to provide the services that most of us believe are needed?

Mr. Whitehead, you started talking about the beneficiaries. It is not just a narrow group, but it is a more broadly defined group in our country. A lot of us benefit from it.

I would ask of Mr. Mayo, Mr. Seidman, and Mr. Whitehead as well, if you were devising a way to raise the revenues, how would you suggest doing it? I think a lot of what needs to be done with respect to Enron should not be done legislatively. I am concluding a lot of it is going to be the market punishing or rewarding certain kinds of behavior.

A fair amount can be done regulatorily and particularly if we provide the resources the SEC needs.

But this particular area, coming up with the revenues to provide for these services, that seems to me an area where we are going to need to legislate. We are going to need to legislate with respect to the appropriations for the SEC so that they will have the resources that they will need to do their job.

My hope is that, despite the concerns that the Chairman expressed about forgetting these lessons and a couple of years down the line, not providing those resources, I think we will remember this one for a while and I am hopeful that we will.

But just help us devise a way of raising the revenues that makes sense, other than simply an appropriation. What comes to mind?

Mr. SEIDMAN. First, let me say that I think keeping it out of the appropriation process gives you a great deal more independence.

The FDIC, we did not have an appropriation because we charged members and it gave us a considerable degree of independence that we would not have had under the appropriation process. I think independence is the key that we are looking for here.

I would simply charge all public companies a certain percentage of the value of their stock at a given date. It will be so small to support this, that I think it will hardly be noticed. On the other hand, it will be automatic and it won't be subject to the problems that you have today with appropriation for the SEC.

Senator CARPER. Fine. Thank you.

Mr. WHITEHEAD. There is a long history for the SEC to charge fees of various sorts to raise parts of their budget, as I am sure you know. Those fees are applied on what are perceived to be the users of that particular service. There is still I believe a registration fee that a company registering with the SEC for a public offering of securities to raise money pays when they file the registration statement a fee. The check has to go along with the registration statement when it is filed.

The collection of those fees as capital markets have grown in some years, all the fees in the aggregate exceeded all the costs of the SEC. But I believe the system is that those fees are turned over to the Treasury and not exactly credited against the SEC's budget. It seems to me that there have been years, and I do not know whether it is still true or not, but when the SEC, when looking at it that way, was a money-making organization for the U.S. Government because the fees that they charged for their regulatory services exceeded their expenses.

Chairman SARBANES. That is right, yes.

Mr. WHITEHEAD. Is that still true?

Chairman SARBANES. That is why we had this bill to cut the fees. But it was not a pass-through like the FDIC. The FDIC got the money for sure.

We had these fees. That was the rationale. But the fees went into the general treasury and the appropriation had to come out of the general treasury, and it by no means matched. So it did not have an automatic nature to it.

Mr. WHITEHEAD. Maybe the Government audit system ought to be audited by auditors that would put it more on a cost-accounting basis.

[Laughter.]

Senator CARPER. Mr. Mayo, want to add anything here?

Mr. MAYO. I will pass. I agree conceptually with Mr. Seidman and I have quoted the statistic before. The SEC budget relative to the stock market capitalization and that ratio has declined over the past couple of decades. I think, conceptually, that is one way to think about the SEC. It is just part of the overhead cost of our stock market.

Senator CARPER. Give me just some quick idea of the magnitude of the decline.

Mr. MAYO. I did this about 5 months ago. I am guessing from memory. It might be down by half or that type of magnitude. It is a significant decline.

Senator CARPER. Okay. Good. Thanks. Mr. Chairman, I think my time has expired.

Since I have missed your testimony, can I just ask a favor. Is there anything as we walk out of here that you would especially want me to keep in mind from what you said in your testimony or what has come out in the questions? Just one germ of an idea that you think is just especially valuable. Not that there weren't many.

Mr. SEIDMAN. Well, I guess the one thing that I would say is, it is clear you are going to have to take action here. To me, this is primarily an accounting scandal and that is where the major focus of your action ought to be.

Senator CARPER. Thank you.

Mr. Whitehead.

Mr. WHITEHEAD. I would say the point that I made that maybe I would have to pick as being the most important of all is to emphasize to you that there is a wonderful cleansing process going on out there in the private sector.

Every company after Enron is looking at their own practices, their own accounting practices and changing them. Every board of directors is looking at its practices—is it tough enough on the management? Is it questioning things that should come up? Every audit committee is looking at what more should it be doing, because nobody wants to be another Enron or to be a director or an audit committee member of another Enron. Every investment banking firm, every security analyst is looking at what can be learned, how can we do a better job with Enron.

So keep watching what is happening out there. Look at what other companies are doing. I hope these hearings continue into a new phase maybe, that you will call various people in and say, what have you done to change your practices as a result of Enron?

You get a feel of what the private sector is doing out there before you jump in with too many new Government regulations.

Senator CARPER. Good. Thank you.

Mr. Mayo.

Mr. MAYO. Give the analysts equal access to information. Fix the disproportionate incentives. All the incentives are out there for securities analysts to say, bye. When you say bye, you get great access. You can get investment banking business. Management participates in every event that you have, and even if the stock goes down, you still get many of those benefits.

If you are objective and critical, then you sometimes have less access. Sometimes you upset people at your own firm. Sometimes the company won't even talk to you.

The incentives are all set. They need to be fixed and analysts need to be given the opportunity to do their job the way that it should be done.

Senator CARPER. Good points. Thank you. Good to see you.

Chairman SARBANES. We thank you all very much. You have been a very helpful panel.

This hearing stands adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR PHIL GRAMM

Mr. Chairman, I want to thank you for the forward-looking nature of these hearings. It is my opinion that Congress, especially the Senate, has not covered itself in glory during this process. However, I think the Banking Committee has done an excellent job.

I think we have focused on the problem, and now we have the legislative responsibility to fix it. I continue to believe that our mission is to try to determine what we could do to improve the current process. As we go through the legislative process, we will need to keep in mind what the benefits and costs are in terms of legislative change. I think we need to come to a delicate balance of the two.

As I have said on many other occasions, I am a firm believer in the legislative equivalent of the Hippocratic oath: First do no harm. I believe there are changes that need to be made, and I think there is a consensus for us to act legislatively. This Committee has a very important responsibility, and if we can put together a bipartisan bill, I believe that it will hold up on the Senate floor and will ultimately become law.

We have heard from many good witnesses in trying to focus our thinking on this subject, and I think we have two excellent panels today. I look forward to hearing from them, and I want to thank each of you for coming and sharing your views and experiences with us. We are long on theory, but short on practical experience.

PREPARED STATEMENT OF SENATOR DANIEL K. AKAKA

Thank you, Mr. Chairman. The increasing number of inaccurate, incomplete, or misleading audits has led to an examination of the system of oversight for the accounting profession. The complex system of oversight currently in use includes seven private organizations, the Securities and Exchange Commission, and State boards of accountancy.

Mr. David Walker, Comptroller General of the United States, told this Committee on March 5, 2002, that "A continuing message is that the current self-regulatory system is fragmented, is not well coordinated, and has a discipline function that is not timely nor does it contain effective sanctions, all of which create a public image of ineffectiveness."

On January 17, 2002, Securities and Exchange Commission Chairman Harvey Pitt proposed a new oversight board to address disciplinary actions against auditors. The Public Oversight Board, a private sector organization which oversees peer reviews and audit quality inquiries, voted on January 22 to disband by March 31. I am pleased that two members of the Public Oversight Board are here to testify.

The Committee has heard recommendations that a new self-regulatory organization be established for the accounting profession. Several witnesses have suggested that the new organization be given the ability to develop rules, handle disciplinary investigations and sanctions, and be provided with funding to ensure its independence. There is a clear need for an improved system of oversight. We must thoroughly examine the proposals.

I look forward to your recommendations on how to improve the system for oversight of the accounting industry and on other accounting and investor protections.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF CHARLES A. BOWSHER

CHAIRMAN, PUBLIC OVERSIGHT BOARD

FORMER COMPTROLLER GENERAL OF THE UNITED STATES

MARCH 19, 2002

Thank you, Mr. Chairman. My name is Charles Bowsher and since late 1999, I have been Chairman of the Public Oversight Board, which was created in 1977 to oversee the voluntary self-regulatory program of the accounting profession. I am pleased to be here today to discuss our observations about recent problems in regulation of the accounting profession, to offer our recommendations for reform, and to discuss the decision of the POB in January to terminate its existence as of March 31 of this year.

I am joined today by Aulana L. Peters, a Member of the POB, a Retired Partner in the law firm of Gibson, Dunn & Crutcher and a former Commissioner of the Securities and Exchange Commission, and by Alan B. Levenson, a Senior Partner at Fulbright & Jaworski, who is Counsel to the POB and former Director of the SEC's Division of Corporation Finance.

The accounting world as it exists today is the outgrowth of a long series of steps taken by Congress, the securities industry, and the major accounting firms over many years since the bleak days of the 1929 stock market crash and the Great Depression that followed in the 1930's.

After the market crash in 1929, Congress enacted a series of reforms that laid the foundation for the system we know today. Chief among them was the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, which included the creation of the Securities and Exchange Commission; the requirement that corporations that sell stock to the public register with the SEC; and that public companies undergo an annual independent audit of their financial statements. The system created in the early 1930's survived for more than 40 years with only minor adjustments.

In the 1970's, however, it was revealed in hearings before the late Senator Frank Church's Subcommittee on Multinational Corporations that some companies had paid bribes to foreign officials to win business and that these payments had been kept secret from auditors and the public. In the aftermath of these revelations, the Congress—under the leadership of this Committee—passed the Foreign Corrupt Practices Act in 1977 to make clear that bribery of foreign officials by American firms is unacceptable.

Another event affecting the accounting profession in the 1970's was the bankruptcy of the Penn Central Railroad—the largest bankruptcy since the 1930's and the Enron failure of its day.

In the wake of the "sensitive payments" scandal, the Penn Central collapse, and audit failures, the late Senator Lee Metcalf of Montana in 1977 chaired a series of hearings to determine whether new Federal regulation of the accounting profession might be appropriate. In response to these hearings, and as an alternative to legislation, the American Institute of Certified Public Accountants (AICPA), in consultation with the SEC and with the support of the Nation's leading accounting firms, created a self-regulatory framework for the profession. To enhance the quality of audits of financial statements of public corporations, peer review was instituted as the cornerstone of the self-regulatory program.

To run the new self-regulatory programs, including peer review, the AICPA created the SEC Practice Section (SECPS), composed of firms that audit the financial statements of public corporations. And to oversee the programs of the SECPS, the independent Public Oversight Board (POB) was created in 1977. Its function is to protect the public interest. Specifically, the POB was created to monitor and comment on matters that affect public confidence in the integrity of the audit process.

I believe peer review—where one accounting firm hires another to review its operations and internal controls—resulted in major improvements. The recommendations that flowed from peer reviews in the early days led to substantive improvements in the quality controls at accounting firms, large and small.

However, even though the new self-regulatory programs were innovative for their time, they were created with some concern and caution.

John C. Burton, a distinguished Professor of Accounting at Columbia University and the Chief Accountant at the SEC when reforms were being made in 1977, warned in testimony before the House Interstate and Foreign Commerce Committee in 1978, that peer review "is likely to be seen as a process of mutual back scratching." He also warned that "it is highly doubtful that a part-time group [POB] can either in fact or perception" provide an effective substitute for statutory regulation.

Harold M. Williams, who was Chairman of the SEC at the time of the reforms in the late 1970's, warned in a speech in January 1978, that the "effectiveness and credibility of the Public Oversight Board depends on its independence, including its willingness to be critical when called for and its ability to make public its conclusions, recommendations, and criticisms." Chairman Williams also made the point that an effective POB could only be effective "if it is not impeded in performing its functions and responsibilities."

Now, a quarter century after the reforms of the late 1970's, I believe events of recent months demonstrate that the warnings of both Dr. Burton and Chairman Williams have come to pass. I have come to the conclusion that the voluntary self-regulatory program needs to be replaced because it has failed to keep pace with challenges faced by the profession. More troubling is the resistance of the profession's trade association, the AICPA, and several of the Big 5 firms to major reform.

Arthur Levitt, the former SEC Chairman, also described this problem in recent testimony before the Senate Banking Committee. "More than three decades ago," he said, "Leonard Spacek, a visionary accounting industry leader, stated that the profession could not 'survive as a group, obtaining the confidence of the public . . . unless as a profession we have a workable plan of self-regulation.' Yet, all along the profession has resisted meaningful oversight."

In 1980, the SEC said in a report prepared for the Senate Committee on Governmental Affairs that the POB has an obligation to "serve as the conscience and critic of the self-regulatory effort." The POB's charter provides that the POB is "to represent the public interest on all matters that may affect public confidence in the integrity, reliability, and credibility of the audit process."

Despite our attempts to serve the public interest and to be the "conscience and critic," the POB has been impeded since I became Chairman in its ability to oversee the profession. Three events are noteworthy in how the POB has been frustrated in its ability for effectively carry out its responsibilities to serve the public interest:

- On May 3, 2000, SECPS took the unprecedented step of notifying the POB that it would refuse to pay for special reviews of public accounting firms. The special reviews in question had been sought by the SEC to determine whether the firms had complied with SEC and professional independence standards. The decision of the SECPS to deny funding to the POB was a serious blow to the notion of independent oversight of the accounting profession. Melvin Laird, the former Congressman and Secretary of Defense and the longest-serving member of the POB, said that this was "the worst incident in my 17 years" on the POB.
- Following the decision to cut off funding of the POB's special reviews requested by the SEC, the largest accounting firms—the Big 5—agreed with the SEC that the POB should instead conduct more limited independence reviews of the large firms. Despite this agreement, the next 21 months were marked by a series of delaying tactics. Because of this lack of progress, the POB, in the end, was unable to conduct the reviews.
- For years, the POB had carried out its oversight responsibilities under a set of bylaws adopted after it was created in 1977. The POB felt that a formal charter would improve the independence of the Board, and a charter was one of the primary recommendations in August 2000 of the Panel on Audit Effectiveness, which was created by the POB at the request of the SEC. However, objections from the AICPA and the Big 5 caused negotiations to drag on for more than a year. Ultimately, a new charter took effect in February 2001.

The recommendations of the Panel on Audit Effectiveness, including a formal charter for the POB, were designed to improve the existing voluntary self-regulatory system, not to create a new regulatory structure for the profession. At the time of the Panel's recommendations in August 2000, neither the POB nor members of the Panel thought it was likely that Congress would approve a statutory self-regulatory organization to govern the profession.

These three events and the frustration they created were among the factors that led the POB to decide, on January 20 of this year, to terminate its existence. But the precipitating event was the announcement by the Chairman of the SEC, Harvey Pitt, of a proposed new regulatory structure for the accounting profession. This plan was worked out in private talks between the SEC and the AICPA and the Big 5 accounting firms with no input from the POB, which had repeatedly been assured that it would be consulted.

The new proposal effectively rendered the POB a "lame duck." The POB believed it could not oversee the activities of the accounting profession under the circumstances and that it would mislead the public to appear to do so. Furthermore, the POB was concerned that were it to continue in operation during an interim period before a new governance structure was in place, it would leave the impression that it approved of the Pitt proposal, which it did not. As "conscience and critic," the POB felt it had no choice but to disband. Only by so acting, we felt, could we protect the public interest. What the POB did was akin to what an auditor does when it believes it must resign from a client engagement because of a fundamental disagreement.

Attached to my testimony, Mr. Chairman, are copies of the letters I sent as Chairman to Mr. Pitt on January 21 and January 31, 2002, detailing the POB's decision to terminate. These letters are attached as Appendices A and B. I would also ask that a letter to the SEC dated March 5, 2002, urging that an independent person be named to conduct the independence reviews which the POB was unable to complete, be made a part of the record.

Mr. Chairman, the current system of self-regulation of the accounting profession has significant problems.

First, the funding of the POB is subject to control by the firms through the SECPS. In the past—as noted above—the SECPS has cut off that funding in an effort to restrict POB activities. In addition, the AICPA and SECPS insisted on a cap on POB funding when the new charter was created.

Second, the disciplinary system is not timely or effective. Disciplinary proceedings are deferred while litigation or regulatory proceedings are in process. This results

in years of delay and sanctions have not been meaningful. The Professional Ethics Division of the AICPA, which handles disciplinary matters against individuals, does not have adequate public representation on its Board. Investigations by the Quality Control Inquiry Committee of the SECPS, which handles allegations of improprieties against member firms related to audits of SEC clients, do not normally include access to firm work papers and firm personnel involved in the engagements under investigation. The disciplinary system cannot issue subpoenas or compel testimony—it must rely on the cooperation of the individual being investigated—and cannot talk to the plaintiff or the client company involved. Furthermore, there is no privilege or confidentiality protection for investigations or disciplinary proceedings, and disciplinary actions are often not made public.

Another problem is that monitoring of firms' accounting and auditing practices by the peer review process has come to be viewed as ineffective, and has been described as "clubby" and "back-scratching." The peer review team does not examine the work of audits that are under investigation or in litigation, and public peer review reports are not informative.

Other problems include the fact that the current governance structure does not have the weight of a Congressional mandate behind it. There is a perceived lack of candid and timely public reporting of why and how highly publicized audit failures and fraud occurred, and what actions have or will be taken to assure that such problems do not recur.

Mr. Chairman, the Public Oversight Board strongly believes that a new regulatory structure for the accounting profession is essential. However, we believe that to be effective, it must be totally independent of the accounting profession and it must be based on the foundation of Congressional action creating a statutory self-regulatory organization.

The Board recommends that Congress create a new Independent Institute of Accountancy—the IIA—and center all regulation under its auspices. A seven-member board would run the Institute totally independent of the AICPA, the Big 5, and other firms. The chair and vice chair would be full time employees of the Institute; five other members would serve on a part-time basis. All would be appointed by a panel composed of the Chair of the SEC, the Chair of the Federal Reserve Board, and the Secretary of the Treasury. Once named, the chair of the IIA would join these three in naming other members of the board. Members of the IIA board could be removed only by a two-thirds vote of the board itself.

The SEC would have oversight of the IIA, and the SEC's Office of the Chief Accountant would be the liaison to the IIA. Attached as Appendix C is a chart showing the organization of the IIA.

Important functions of the Institute would include:

- The IIA would exercise oversight for all standard setting for accounting, auditing, and independence, and their interpretation. Accounting standards are just as important as auditing and independence standards. For this reason, the POB believes the Financial Accounting Standards Board must be brought under the umbrella of the IIA, which would take responsibility for its oversight and funding.
- Firm-on-firm peer review would be discontinued for firms that audit more than 100 public corporations each year. In its place, IIA employees would conduct thorough and comprehensive yearly reviews of the annual internal inspections of such firms. Unlike peer review, no activities of a firm would be off limits to Institute reviewers and the process would produce detailed public reports. For firms that audit less than 100 public corporations yearly, reviews would be performed by other firms selected by the IIA. Their reports would be addressed to the IIA as the client of the reviewer. In addition to the reviews, IIA employees would conduct special reviews, when warranted. Similar to those the SEC originally asked the POB to undertake, these reviews could take a systemic, in-depth look at a firm's systems, policies, procedures, and operations. If necessary, such special reviews would delve into questions affecting the firm's compliance with applicable professional standards. As with the yearly reviews, reports of these special reviews would be public.
- An Office of Enforcement and Discipline within the IIA would have full authority to investigate allegations of wrongdoing by public accounting firms and their personnel. The POB recommends giving the IIA the privilege of confidentiality, as well as the power of subpoena to compel testimony and produce documents. Cases of alleged misconduct would be brought before IIA hearing examiners. When warranted, these examiners would recommend to the IIA board the imposition of sanctions, ranging from fines to expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, State boards of accountancy, or other agencies, as appropriate.

- Funding would be provided through fees imposed on public corporations in amounts sufficient to cover the costs of the Institute. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May of 2000.
- The IIA would be charged with coordinating international liaison and overseeing continued professional education for those in the profession.

Beyond these functions, the POB recommends that:

- With regard to nonaudit services for audit clients, the POB recognizes that there has been disagreement on restricting scope of services and that various models have been suggested for what should be allowed and what should be excluded.

  The POB strongly agrees with a point made in President Bush's 10-point reform plan that "Investors should have complete confidence in the independence and integrity of companies' auditors." The specifics on the President's plan recognize the importance of prohibiting certain nonaudit services in order to safeguard auditor independence.

  The POB takes note of a statement issued by the AICPA on February 1, 2002, in which it affirmed that it "will not oppose Federal legislation restricting the scope of services that accountants may provide their public audit clients, specifically in information technology and internal audit design and implementation."

  Against this background, the POB proposes that SEC regulations concerning independence be legislatively codified with appropriate revisions to update restrictions on scope of services involving information technology and internal audit services as noted above. At the same time, the POB believes such legislation should affirm that tax work not involving advocacy and attest work by audit firms in connection with SEC registration and other SEC filings be allowed. The POB also believes that small public businesses, to be defined by the SEC, should not be subject to any restriction on nonaudit services for audit clients. Further, with respect to nonpublic corporations, it is the POB's position that such corporations and the accounting firms that audit them should not be subject to any restriction on nonaudit services. We expressly emphasize this to avoid misunderstanding and any consequences to small business and small audit firms.

  The IIA Office of Standards should be empowered by legislation to promulgate appropriate rules affecting independence to cover changing circumstances.

  The POB believes there should be no prohibition against an audit firm offering nonaudit services to nonaudit clients.
- Auditors should be rotated every 7 years. As a corollary, public corporations would be prohibited from firing auditors during their term of service unless such action is determined by the audit committee to be in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC.
- Engagement and other partners who are associated with an audit should be prohibited from taking employment with the affected firm until a 2 year "cooling off" period has expired.
- The Institute should expand on the recommendations of the recent Blue Ribbon Committee which made it clear that the external auditor should be accountable to a firm's board of directors and its audit committee and not to management. Specifically, the audit committee should take full responsibility for hiring, evaluating, and—if necessary—terminating an audit firm.
- To discourage conflicts of interest involving public corporations, Congress should amend the Securities Exchange Act of 1934 to require more meaningful and more timely disclosure of related party transactions among officers, directors, or other affiliated persons and the public corporation. Such disclosures should be made promptly in current reports, as well as in proxy statements filed with the SEC.
- Management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. The corporation's chief financial officer and chief executive officer should sign this attestation and the auditor should review it. An auditor's review and report on the effectiveness of internal controls would—as the General Accounting Office (GAO) found in a 1996 report—improve "the auditor's ability to provide more relevant and timely assurances on the quality of data beyond that contained in traditional financial statements and disclosures." Both the POB and the AICPA supported the recommendation when the GAO made it, but the SEC did not adopt it.

The POB feels that these reforms are necessary if trust is to be restored in the accounting profession. The Board has presented what it believes is a sensible, workable plan for reform. It is premised on the firmly held belief that the fundamental

purpose of regulation is to serve the public interest and that of investors. If this is to be accomplished, regulation must be totally independent of the profession, it must pull together all aspects of regulation from standards to discipline, it must be transparent, and it must provide for adequate funding and staff.

A decade ago this Committee was in the forefront of enacting major reforms for the banking industry—reforms that were widely opposed by the banks and by their lobbyists. Opponents then predicted gloom and doom for the industry should the proposed reforms be enacted. In reality, the reforms contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 repaired flaws in regulation of the Nation's banking industry. More important, they significantly strengthened the industry.

Today, the Congress again is called upon to institute reform. In the wake of the Enron debacle, the POB, acting as the "conscience and critic" of the profession, strongly believes that to protect investors and the public, the old system of voluntary self-regulation for the accounting industry must be replaced. While many will urge that Congress act with caution and that the profession be again given the opportunity to fix the present system with marginal changes, the POB believes it is time to resist the continuation of the status quo and move ahead with fundamental change.

Mr. Chairman, you recently made the point that recent events have had a "critical impact on the national confidence in the financial markets" and that the time has come to "focus on the protection of investors and the efficient functioning of our capital markets." I could not agree more. That is why I believe it is time to resist continuation of the status quo and move ahead with fundamental change.

Mr. Chairman, this concludes my prepared testimony. I would be happy to answer any questions you may have.

APPENDIX A

January 21, 2002

Via Facsimile and Federal Express

The Honorable Harvey L. Pitt
Chairman
Securities and Exchange Commission
Judiciary Plaza
450 Fifth Street, N.W., Room 6000
Washington, DC 20549

Dear Chairman Pitt:

I am writing to inform you that the Public Oversight Board voted unanimously on Sunday, January 20, 2002 that it intends to terminate its existence pursuant to Section IX of the POB's Charter no later than March 31, 2002. A copy of our resolution of intent to terminate is enclosed.

This decision was made reluctantly, but members of the Board felt we had no other recourse. It was obvious from your remarks at the press conference on January 17th that the proposals for changing the system of self-regulation of the accounting profession do not include a place for the POB. An oral outline of the proposed changes was provided to us, shortly before your announcement, by the President of the AICPA and the Chair of the SEC Practice Section ("SECPS") Executive Committee. They, along with Big 5 representatives, apparently had been in talks with you on this matter for some time. It is significant that there was no consultation with the POB, which is charged with representing the public interest, before these proposed changes were announced.

In voting its intent to terminate, the POB recognizes that arrangements must be made for a transition of its responsibilities, especially with respect to the continued oversight of the SECPS, the Auditing Standards Board, the Peer Review Committee, and the Quality Control Inquiry Committee, as well as monitoring the implementation of the recommendations of the Panel on Audit Effectiveness. Also, plans must be made to transfer from the POB to an independent entity the conduct of and issuance of, public reports on, the special independence reviews of the Big 5 accounting firms, agreed to by the SEC and the firms in June 2000. Beyond this, decisions must be made about the POB's staff. While there will undoubtedly be other matters to deal with, we anticipate that it will be possible to work out suitable arrangements no later than March 31st.

We believe that the events of recent weeks surrounding the collapse of Enron have precipitated a tremendous concern about the manner in which the accounting profession conducts its business and serves the public interest. As Chairman of the POB, it has been my pleasure to serve with a group of outstanding Board members and a fine staff, dedicated to the public interest. The members of the Board look forward to working with

Congress, the SEC, and various members of the profession in arriving at reforms that will enhance our capital markets and restore public confidence in the integrity of the system.

Sincerely,

Charles A. Bowsher
Chair

Enclosure

cc: James C. Castellano
Chair
AICPA (with enclosure)

Barry C. Melancon
President and CEO
AICPA (with enclosure)

Robert J. Kueppers
Chair
SEC Practice Section (with enclosure)

APPENDIX B

POB PUBLIC OVERSIGHT BOARD
One Station Place *(203) 353-5300*
Stamford, CT 06902 *Fax (203) 353-5311*
www.publicoversightboard.org

January 31, 2002

VIA FACSIMILE and Federal Express

The Honorable Harvey L. Pitt
Chair
United States Securities and Exchange Commission
Judiciary Plaza
450 Fifth Street, N.W., Room 6000
Washington, D.C. 20549

Dear Harvey:

After having given serious consideration to the matters discussed with you and the content of your letter of January 22, 2002, and having consulted with the leadership of the AICPA and the SECPS – Executive Committee, the Board believes it would not serve the public interest for it to continue.

The Board believes it would be against the interests of the public for us to continue to function in the future. Given the recent events and the SEC's proposal for a new structure, we believe that we cannot effectively oversee the activities of the accounting profession and it would mislead the public to seem to do so.

We will work diligently to bring about an orderly transition of POB projects, including oversight of the SECPS Self Regulatory Programs, with the expectation that this can be completed by March 31st, unless the Board determines otherwise. Our staff shall be available to assist for whatever period may be required.

We shall be guided by the public interest in wrapping up our projects and in giving input to you, the Congress and the profession in the development of a new model for private sector regulation. We believe that regulation of the profession can and should be improved and commit to working with you and others in accomplishing this important goal.

Sincerely,

Charles A. Bowsher
Chair

cc: Robert J. Kueppers, Chair
SEC Practice Section – Executive Committee
cc: Messrs. James C. Castellano, Chair, and Barry C. Melancon, President and CEO, of the AICPA

PUBLIC OVERSIGHT BOARD

News

PUBLIC OVERSIGHT BOARD
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March 5, 2002

Via Federal Express

John M. Morrissey
Deputy Chief Accountant
Office of the Chief Accountant
United States Securities and Exchange Commission
450 5th Street, N.W.,
Room 11214
Washington, DC 20549

Robert J. Kueppers
Chair
SEC Practice Section
Executive Committee
c/o Deloitte & Touche LLP
Ten Westport Road
Wilton, CT 06897-0820

Dear Messrs. Morrissey and Kueppers:

I. Purpose

The purpose of this letter is to follow-up on my letter, as Chair of the Public Oversight Board ("POB"), to Harvey L. Pitt, Chair of the Securities and Exchange Commission ("SEC"), dated January 21, 2002, concerning the POB's intention to terminate its existence no later than March 31, 2002, and the need for arrangements to be made for a transition of the POB's responsibilities. In that January 21st letter, I stated that plans must be made to transfer from the POB to an independent person the POB's responsibility for the conduct of, and issuance of public reports on, the reviews of the Big 5 accounting firms agreed to by the SEC and the firms in June 2000. This agreement between the firms and the SEC is set forth in the "Term Sheet for Independence Look-Back Testing Program" ("Term Sheet").

On February 20, 2002, Mr.Morrissey, as SEC Deputy Chief Accountant, wrote a letter addressed "To Participants in the Independence Look-Back Testing Program and the Public Oversight Board" in which he stated the SEC staff was withdrawing its request that the POB conduct reviews and issue reports under the Term Sheet because of the POB's intention to terminate its existence. Mr. Morrissey's letter asked that the firms develop "an alternative approach" to the POB doing these reviews and reports that "must be acceptable to the SEC staff and must provide investors with a comprehensive and reasoned report on the independence systems of the participating firms, as originally contemplated by the Term Sheet." Mr. Morrissey's letter also pointed out that the program under the Term Sheet "is more important to investors than ever before."

In view of the foregoing, and in the interest of an appropriate transition, the POB in

this letter sets forth its position ("Position") on the transfer of its responsibility for conducting reviews and issuing reports pursuant to the Term Sheet to an independent person (e.g., individual, group, firm or entity) ("Independent Person").

II. Term Sheet

The Term Sheet was announced by the SEC in a public release on June 7, 2000. The Term Sheet calls for the POB to conduct reviews and oversight of, and issue public written reports ("Reports") on, the effectiveness of the systems, procedures and internal controls relating to independence ("Systems and Controls") of the Big 5 U.S. public accounting firms (Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP) ("Firms").[1] The reviews and oversight of, and public written reports on, the Firms' Systems and Controls pursuant to the Term Sheet are collectively referred to as the "Reviews."

The Firms agreed in the Term Sheet "to cooperate with the POB" in the Reviews.

The Term Sheet provides in relevant part:

- Systems and Controls. Firms would continue to implement the systems, procedures, and internal controls relating to independence set forth by the Commission's Chief Accountant, in letters to Michael Conway, Chairman of the SEC Practice Section Executive Committee, dated December 9, 1999 and May 1, 2000, with implementation to be completed no later than January 1, 2001.
    - Firms would submit to review and oversight by the POB of the effectiveness of the design and implementation of these systems, procedures, and internal controls, and to testing by the peer reviewers or the POB of their effectiveness. If the testing is performed by a peer reviewer, the POB shall have oversight of the peer review. Firms would agree to cooperate with the POB in such review and oversight. The POB would issue public written reports with respect to (i) the design effectiveness and implementation of these systems, procedures and internal controls as of January 1, 2001, and (ii) the testing and evaluation of their operating effectiveness during the six-month period ending June 30, 2001. Such reports will not disclose violations.

III. POB Work on the Reviews

The Term Sheet states that the Reviews are to be conducted, and the Reports issued, by the POB. The POB, as its Charter states, is an "independent" entity. The POB, pursuant to the Term Sheet, has done a substantial amount of work in preparing to conduct the Reviews. This work, beginning in November 2000, includes, as discussed below, participation in a series of meetings and telephone conferences with the Firms and SEC staff that took place during the thirteen-month period between December 2000 and January 2002. In addition, as discussed below, the POB prepared a draft request for information and documents pursuant to the Reviews, furnished it to the Firms and SEC staff on May 22, 2001, and requested any comments. Thereafter, the POB finalized this draft request and sent it to the Firms on July 23, 2001 and to the SEC staff on August 1st. The POB prepared a draft work program for the first phase of the Reviews, and furnished it to the Firms and SEC staff on October 12, 2001. The POB also prepared a draft work program for the second phase of the Review and sent it, together with the first phase draft program, to the Firms and SEC staff on January 17, 2002, for comments. In addition, the POB has had correspondence, meetings, and telephone conferences with the Firms regarding a proposed confidentiality agreement for the Reviews going back to July 2001. Issues pertaining to this proposed confidentiality agreement were not resolved, and representatives of the Firms didn't appear at the last meeting to

discuss those issues scheduled for December 18, 2001.

IV. Transition of POB Responsibilities

While the POB has done substantial work on the Reviews, and through the middle of January 2002 had planned on moving forward to complete these Reviews, it no longer, because of recent developments, is in a position to do so. As you know, the POB presently intends to terminate its existence no later than March 31, 2002, in accordance with its resolution unanimously approved on January 20, 2002. In my letter to SEC Chair Pitt dated January 21, 2002 discussing this resolution, I pointed out that his proposals for changing the system of self-regulation of the accounting profession, announced at his press conference on January 17, 2002, did not include a place for the POB. In addition, I noted that while the SEC had apparently been in talks with the American Institute of Certified Public Accountants ("AICPA"), SEC Practice Section ("SECPS") Executive Committee and representatives of the Big 5 Firms on these proposals for some time,[2] there, significantly, had been no consultation on the proposals with the POB, which is charged with representing the public interest. I also stated in this letter that, in voting its intent to terminate, the POB recognized that arrangements must be made for a transition of its responsibilities, including plans to transfer the POB's responsibility for the Reviews and Reports from the POB to an Independent Person.[3]

As part of the transition of responsibility for the Reviews and Reports, and in a continuing effort to move these Reviews and Reports forward, the POB submits its Position to the SEC and the Firms. The POB, based on its work to date, believes that it would be in the public interest, and in furtherance of the Term Sheet, for the Reviews and Reports to be done by an Independent Person as soon as reasonably possible in a manner consistent with this Position. The POB believes this is particularly important, given the serious and widespread concerns that have been recently expressed in Congressional hearings on the Enron collapse, as well as in the media, with respect to auditor independence.

V. Executive Summary

In a letter to the POB dated December 9, 1999, the then-SEC Chief Accountant expressed concern that public accounting firms possibly lacked adequate quality controls for independence. As a step to "safeguard the public interest," he "strongly recommend[ed]" that the POB undertake "a special review of SECPS member firms' current compliance" with independence requirements. On December 21, 1999, the POB agreed to do so. Shortly afterwards, on January 6, 2000, the SEC announced that an internal investigation at PricewaterhouseCoopers LLP ("PwC") had disclosed more than 8,000 independence violations there. At this time, there were publicly-expressed concerns that the widespread independence violations at PwC might also be found at the other large accounting firms if they were subject to a review of their compliance. The POB commenced preliminary work on the special reviews in January 2000, and had meetings with firm representatives to discuss the reviews.

Then, in early May 2000, the POB's work on the special reviews was brought to a halt. At that time, the SECPS sent a letter to the POB dated May 3rd cutting off the POB's funds for the special reviews. The then-Chair of the SEC stated that this May 3rd letter was "a significant setback to self-regulation and independent oversight" and raised "serious questions as to the profession's commitment to self-regulation." The special reviews did not go forward. In June 2000, the SEC and the Firms entered into the Term Sheet, which calls for the POB to conduct the instant Reviews.

Subsequently, on October 10, 2000, the POB received a letter from the then-SEC Chief Accountant asking that the POB do the Reviews called for by the Term Sheet "in lieu of" the special reviews previously requested in his December 1999 letter to the POB. The POB agreed to do so, and commenced preliminary work on the

Reviews in November 2000. Between then and January 2002, a period of more than a year, the POB did a substantial amount of work preparing to conduct the Reviews. Despite these efforts, by the middle of January 2002 the POB still had not been able to obtain information and documents for the Reviews it had requested from the Firms in July 2001.

The primary reason for this delay in the POB's work was a lack of progress in the Reviews. For example, the POB's efforts to enter into a confidentiality agreement with the Firms, going back to July 2001, did not lead to an agreement. Moreover, this lack of progress in the Reviews was one of the factors that led to the POB voting to terminate its existence.

The POB believes it is important for the public interest that the Reviews and Reports be completed by an Independent Person as soon as reasonably possible. To this end, there should be a prompt transfer of the POB's responsibility for the Reviews and Reports to an Independent Person. This is particularly important, given the serious and widespread concerns that have been expressed in recent Congressional hearings on the Enron collapse, as well as in the media, with respect to auditor independence. As Mr. Morrissey pointed out in his letter to the Firms and the POB dated February 20, 2002, the program under the Term Sheet "is more important to investors than ever before."

The SEC staff, in a revised draft letter dated December 14, 2001, has set forth proposed terms for the Reviews. The POB does not believe it would be in the public interest for the Reviews to be done in the manner called for by this draft letter. In particular, the POB believes that the limitations in the draft letter on the scope of the Reviews, and on the form and content of the Reports, would be an undue constraint on the Independent Person, which would raise questions about the independence of the process. Instead, the Reviews should be conducted, and the Reports issued, in the manner determined appropriate by the Independent Person, consistent with the Term Sheet and in furtherance of the public interest.

In this regard, the POB believes that its Position set forth in this letter, based on its substantial work on the Reviews, could be helpful to the Independent Person. For example, the POB believes the Reports should be written in "plain English" with informative, meaningful and transparent disclosure. In addition, the Independent Person's significant observations and recommendations concerning the Firms' Systems and Controls should be included with the Reports not, as the SEC revised draft letter proposes, omitted from the Reports and put in letters of comment in the AICPA public peer review files.

VI. Background

Some background would be helpful in considering this matter.

On January 14, 1999, the SEC announced its enforcement action and settlement against PwC for violations of the SEC independence rules. As part of this settlement, PwC agreed, among other things, to conduct a firm-wide internal investigation supervised by an independent consultant. The report on this internal investigation, announced by the SEC on January 6, 2000, disclosed there had been more than 8,000 independence violations at PwC. This received a lot of publicity. A number of commentators questioned whether the widespread independence violations at PwC might also be found at the other large accounting firms if they were subject to a review of their compliance.

On December 9, 1999, less than a month before this public announcement, the then-Chief Accountant of the SEC, Lynn Turner, sent a strongly-worded letter to the SECPS Executive Committee, expressing concern with the adequacy of SECPS member firms' independence quality controls. The SEC Chief Accountant set forth in this letter what he called "[t]he basic requirements" of an independence quality

control system, and said that "revised [SECPS] membership requirements incorporating [these]" should be implemented "no later than January 1, 2001."

On the same date as this letter to the SECPS Executive Committee, the SEC Chief Accountant also sent a letter to the POB, expressing concern that public accounting firms may lack adequate quality controls for independence. In this letter, as a step to "safeguard the public interest," he "strongly recommend[ed] that the POB undertake a special review of SECPS member firms' current compliance" with independence requirements. In response, on December 21, 1999, the POB agreed to do so. The POB commenced preliminary work on the special reviews in early 2000, and had meetings with firm representatives to discuss the reviews.

On January 5, 2000, the POB placed in the public file of all SECPS member firms a letter discussing the above-mentioned December 9, 1999 letters from the SEC Chief Accountant to the SECPS Executive Committee and the POB. The POB's letter gave notice to users of SECPS member firms' peer review reports that existing peer review standards had not been adjusted to include additional tests that could be required in the future, as a result of actions taken in response to these two SEC letters.

On May 1, 2000, in another letter to the SECPS Executive Committee, the then-SEC Chief Accountant again raised concerns with the adequacy of SECPS member firms' independence quality controls, and asked that certain steps be taken to improve these controls.

Later in May 2000, the POB's work on the special reviews was brought to a halt. At that time, the SECPS sent a letter dated May 3rd to the POB stating that it would not approve or authorize payment for the special reviews. Within a few days, on May 5th and 8th, the POB received letters from two of the Firms (PwC and Ernst & Young LLP ("E&Y") stating that they knew nothing of the May 3rd letter before it was sent, and that the letter did not represent the position of their firms.

In a speech on May 10, 2000, the then-Chair of the SEC, Arthur Levitt, stated that this May 3rd letter was "a significant setback to self-regulation and independent oversight" and raised "serious questions as to the profession's commitment to self-regulation". In addition, he noted that Melvin Laird, the longest-serving member of the POB and former Secretary of Defense, had said this was "the worst incident in my 17 years on the POB's Board."

After this cut off of funding, the special reviews did not go forward.

The following month, June 2000, the SEC and the Firms entered into the Term Sheet. This Term Sheet requires the Firms to (i) participate in a voluntary look-back program to report any past violations of auditor independence rules, under the oversight of an independent counsel selected by the Firms with non-objection from the SEC, (ii) complete implementation of the systems and controls in the above-mentioned SEC December 1999 and May 2000 letters by January 1, 2001, and (iii) submit to the Reviews by the POB.

The POB was not involved in the negotiations on, nor was it a party to, the Term Sheet. Further, at the time they entered into the Term Sheet, the Firms and SEC did not request the input of the POB on the scope of the Reviews or the form and content of the Reports.

In a letter dated September 13, 2000, which was received by the POB on October 10, 2000, the then-SEC Chief Accountant asked that the POB conduct the Reviews called for by the Term Sheet "in lieu of the special review requested in my December 9th [1999] letter to you". The POB agreed to do so.

The POB commenced preliminary work on the Reviews in November 2000. At the POB meeting on December 4, 2000, the then-Chair of the SECPS Executive Committee suggested a deferral of commencement of the Reviews for various reasons, including the Firms' pending work on the "look-back reviews" (also called for by the Term Sheet) and their gearing up for compliance with new SEC independence rules (which were to become effective in early 2001).

The next month, on January 19, 2001, POB representatives met with the then-Chief Accountant and then-General Counsel of the SEC, as well as other members of the SEC staff, to discuss the Reviews and Reports. The discussion at the meeting focused on a number of issues concerning the Reviews, including the proposed deferral.

Subsequent to the January 2001 meeting, and continuing through May 2001, POB representatives spent a substantial amount of time reacting to, and furnishing comments on, the SECPS's Joint Task Force on Independence and Quality Controls ("Task Force") draft White Paper, which was designed to, among other things, support a deferral of commencement of the Reviews. In particular, from March to June 2001, POB representatives, in meetings and telephone conferences, discussed with the Task Force five different drafts of this Task Force White Paper. It was apparent from these discussions that the Firms had very different views than the SEC staff on the meaning of certain provisions of the Term Sheet and how the Reviews should be done.

Because this matter was taking longer than expected, the POB started work on a draft request to the Firms for documents and information for the Reviews. This draft request was furnished to the Firms and SEC staff on May 22, 2001, and comments were requested. Work also continued on the White Paper, but in mid-June 2001, the POB was advised that the Task Force had decided not to go forward with its proposal to defer the Reviews.

On July 23, 2001, after receiving comments from the Firms and SEC staff, the POB sent to them the final version of its request for information and documents. This request asked the Firms to complete their submission of information and documents in response to the request "as soon as possible, but in no event later than August 31, 2001." The cover letter with the request pointed out that POB representatives wanted to meet with the Firms "as soon as possible to work out confidentiality agreements" for the Reviews, and asked "that this be done as soon as feasible in order to expedite the POB's work" on the Reviews. The cover letter also requested that the Firms, in the meantime, "furnish [the POB] with any written information and documents in response to the [r]equest which you are willing to provide prior to the execution of a confidentiality agreement." The Firms have not provided the POB with the information and documents it requested on July 23, 2001.

A letter from POB counsel to the Chair of the Task Force dated July 23, 2001 ("July 23rd Letter"), which was copied to the Firms, set forth the POB's position on significant open issues concerning the Term Sheet and Reviews that had been raised (in some instances for the first time) in a July 6, 2001 letter to the POB from the Chair of the Task Force. These issues concerned the scope of the Reviews, including with respect to foreign-associated firms, the standards to be used by the POB in the Reviews for evaluating the effectiveness of the Firms' Systems and Controls, the form and content of the POB's Reports, the POB's work programs for the Reviews, a confidentiality agreement to cover the information and documents submitted by the Firms to the POB in the Reviews, and the timing for the Reviews. With regard to a confidentiality agreement, the POB's July 23rd Letter stated that the Term Sheet required the POB to "issue public written reports" on the Reviews, and that, "[c] onsistent with this requirement," the POB would be pleased to work with Firm representatives to develop a confidentiality agreement for the Reviews. This July 23rd Letter also stated that POB representatives wanted to meet with the Firms on a

confidentiality agreement "as soon as feasible," and asked that the Firms contact the POB "to arrange a date and place for the meeting." The Firms to date have not entered into a confidentiality agreement with the POB.

On July 24, 2001, POB representatives met with E&Y. In an effort to move forward on the Reviews, the POB representatives proposed that the POB conduct a prototype Review of E&Y. The POB and E&Y exchanged draft correspondence on, and further discussed, this prototype Review, but it did not go forward.

On August 10 and 21, 2001, POB representatives met with representatives of the SEC and discussed, among other things, the status of the Reviews and certain open issues that still had not been resolved.

During the fall of 2001, POB representatives and the Firms continued to discuss open issues concerning the Reviews, some of which had been the subject of continuing POB discussions with the Firms and the SEC staff going back to January 2001. For example, POB representatives met with the Firms on September 11th in New York City to discuss issues concerning the scope of the Reviews and the form and content of the Reports. In response to the Firms' request at this meeting, POB representatives on September 17, 18 and 25, and October 1 and 2, 2001, visited the five Firms for preliminary presentations on their independence systems.

On October 12, 2001, the POB sent to the Firms and SEC staff a draft "POB Preliminary Work Program for Phase I (Design and Implementation) of Oversight Reviews of Firm Systems and Controls Relating to Independence" ("Phase I Draft Work Program"). This Draft Work Program contains work steps for evaluating whether a Firm's Systems and Controls were effectively designed and implemented. The focus of these work steps is on nine elements of Firm Systems and Controls:

- written independence policies and procedures;
- automated tracking system and restricted entity list;
- independence training;
- internal monitoring;
- senior management and others responsible for independence;
- "tone at the top" and culture relating to independence;
- prompt reporting of personnel employment negotiations;
- reporting by personnel of apparent independence violations; and
- a disciplinary mechanism.

On October 15 and 17, 2001, POB representatives again met with the SEC staff to discuss the Reviews. Later in the month, the POB submitted two letters to the staff (dated October 19th and 23rd) with additional information, including correspondence between the Firms and the POB, concerning the Reviews.

On October 25, 2001, representatives of the POB, Firms and SEC staff met at the offices of the SEC to discuss the Reviews. This meeting was followed by an SEC staff draft letter dated November 5th setting forth proposed terms for the Reviews. On November 7th, a second meeting between representatives of the POB, Firms and

SEC staff was held at the SEC offices to again discuss the Reviews. This meeting was followed by a second SEC staff draft letter dated November 15th containing revised proposed terms for the Reviews.

Pursuant to the discussion at the above-mentioned October 25, 2001 meeting, two meetings were held between the Firms and POB representatives to discuss a confidentiality agreement for the Reviews, one on November 13th (three Firms present), and the other on November 26th (four Firms present). In addition, another meeting to discuss a confidentiality agreement was scheduled for December 18th in New York City, but the Firms, without prior notice, did not attend. POB counsel was later told that day the Firms had decided to postpone the meeting, and that the POB should have been, but inadvertently was not, told of the postponement.

On December 10, 2001, POB representatives met with representatives of the SEC to discuss, among other matters, the Reviews.

On December 14, 2001, the SEC staff issued a third draft letter ("SEC Revised Draft Letter") discussing further changes in proposed terms for the Reviews. On December 17th and 19th, POB counsel gave extensive comments to the SEC staff on this Revised Draft Letter.

On January 9, 2002, POB representatives met with the chief executive officers of two of the Firms, as well as the Chair of the SECPS Executive Committee, to further discuss the Reviews.

On January 17, 2002, the POB sent to the Firms and the SEC staff a draft "POB Preliminary Work Program for Phase II (Operating Effectiveness) of Oversight Reviews of Firm Systems and Controls Relating to Independence" ("Phase II Draft Work Program"). This Draft Work Program contains work steps to test the operating effectiveness of Firm Systems and Controls, with a focus on the same nine elements included in the Phase I Draft Work Program. In a cover letter, the POB requested comments on both the Phase I and Phase II Draft Work Programs by January 31st.

Although the POB did substantial work preparing to conduct the Reviews, going back to November 2000, by January 2002 it still had not been able to obtain the information and documents it requested from the Firms in July 2001. The POB believes that the time, effort and expense associated with much of its work on the Reviews could have been avoided if more progress had been made in the Reviews.

For context here, it should be noted that in a letter dated January 17, 2001, Congressman John Dingell, Ranking Member of the House Committee on Energy and Commerce, requested the U.S. General Accounting Office ("GAO") to conduct a study of the accounting profession's governance system. In a subsequent letter dated June 7, 2001, Congressman Dingell asked the GAO to include in this study, among other matters, the adequacy and effectiveness of the Reviews. Further, it is evident from recent media coverage, as well as Congressional hearings on the Enron collapse, that Congress has increased its focus on the accounting profession, including auditor independence.

VII. POB'S Position

As previously noted, in a letter to SEC Chair Pitt dated January 21, 2002, I stated that, in view of the POB's intention to terminate its existence no later than March 31, 2002, and as part of the transition, plans must be made to transfer responsibility for the Reviews and the Reports from the POB to an Independent Person.

The POB believes that, consistent with the Term Sheet, and to further the public interest, the Reviews should be performed, and the Reports issued, by an

Independent Person. The Firms have previously suggested that the Reviews be conducted, and the Reports issued, by the peer reviewers of the Firms. The POB, as it told the Firms at the time, does not agree with this approach because it is not in accordance with the Term Sheet. Concerns regarding the peer review process recently expressed by Congressmen and others also indicate peer reviewers should not be given responsibility for the Reviews and Reports.

In addition, the POB does not believe the Reviews should be conducted, and the Reports issued, as proposed in the SEC Revised Draft Letter.[4] Rather, it is the view of the POB, based on its work on the Reviews, that the Reviews and Reports should be done by an Independent Person in the manner discussed below. In particular, the Reports should be written in "plain English" with informative, meaningful and transparent disclosure, in furtherance of the public interest.

A. Scope of Reviews

The POB believes that, in evaluating the "effectiveness" of the design, implementation and operation of the Firms' Systems and Controls pursuant to the Term Sheet, the Independent Person should determine whether those Systems and Controls provide reasonable assurance of compliance with applicable SEC, AICPA, SECPS and Independence Standards Board ("ISB") independence requirements (collectively, "Independence Requirements").

B. Form and Content of Reports

It is the position of the POB that the "public written reports" on the design, implementation and operating effectiveness of the Firms' Systems and Controls called for by the Term Sheet should be in "plain English" with meaningful disclosure. Moreover, these Reports should be "informative [so] that the public clearly understand[s] what has occurred," as stated in the letter from Mr. Morrissey, as SEC Deputy Chief Accountant, to POB counsel dated July 13, 2001.

In addition, the POB believes that the Independent Person should include in the Reports a discussion of the following:

- A description of the scope, methodology, and work performed.
- A description of each Firm's U.S. practice, including lines of business, and the approximate number of partners and professionals covered by the Independence Requirements.
- A description of the Firm's policies, procedures and practices to achieve compliance with the Independence Requirements.
- A description of the findings and evaluation of whether the design, implementation and operating effectiveness of the Firm's Systems and Controls provide reasonable assurance of compliance with the Independence Requirements.
- If the Firm's System and Controls provide reasonable assurance there was compliance with the Independence Requirements, but there were significant deficiencies in the design, implementation or operating effectiveness of the Firm's Systems and Controls, then observations and recommendations concerning those deficiencies would be set forth in an appendix attached to the Reports. This appendix would also include any letter from the Firm in response to these observations and recommendations.
- Any observations and recommendations relating to deficiencies that were not

significant would be communicated in writing to the Firm, but not included in the Reports.

- Identification of any "best practices" observed.

- Any recommendations to the SECPS or other standard setters on the development of a written document, or other appropriate action, with respect to "best practices."

The SEC Revised Draft Letter does not take this approach. It proposes that the scope of the Reviews, and the form and content of the Reports, be more limited, as specified in that Letter. For example, the Draft Letter states that significant observations and recommendations on the Firms' Systems and Controls should not be part of the Reports, but instead put in letters of comment in the AICPA's public peer review files.

The POB does not agree that the form and content of the Reports on the Reviews should be limited as proposed in the SEC Revised Draft Letter. Such limitations would be an undue constraint on the Independent Person in a manner that, in the POB's view, is not consistent with the Term Sheet.

The POB, in particular, does not agree with the proposal in the SEC Revised Draft Letter that significant observations and recommendations be omitted from the Reports, and instead placed in letters of comment to the Firms, with copies put in the AICPA public peer review files.[5] The POB believes that significant observations and recommendations constitute important information that should be readily available to readers of the Reports and other members of the public. Further, physically separating the significant observations and recommendations from the Reports would likely be viewed as a device intended to make it more difficult for readers of the Reports to have ready access to that information. The rationale in the SEC Revised Draft Letter that these significant observations and recommendations, if placed in the Reports, could be "confusing" or distracting to readers is not persuasive, particularly given the SEC's mandate for "full and fair disclosure" and the transparency in other reporting processes.

The POB believes that the Independent Person, as the party responsible for conducting the Reviews and issuing the Reports, should have the discretion, within the parameters of the Term Sheet, to determine the form and content of the Reports based on its findings in the course of the Reviews. To provide otherwise would raise questions about the independence of the process.

C. <u>Work Programs for the Reviews</u>

The POB believes that it would be in the public interest for the Independent Person to use the Phase I and Phase II Draft Work Programs in its conduct of the Reviews. These Draft Work Programs were prepared by Tucker Alan, Inc., auditing and systems consultants to Fulbright & Jaworski L.L.P. ("F&J"), counsel to the POB for the Reviews and Reports. In developing these Draft Work Programs, Tucker Alan received input from Jerry Sullivan, Executive Director of the POB; Henry Jaenicke, independence consultant to F&J; George Fritz and David Pearson, auditing and peer review consultants to F&J; and attorneys at F&J working on the Reviews. A substantial amount of time, effort and expense was spent in developing the Draft Work Programs, and the POB believes they would be very helpful to the Independent Person in conducting the Reviews.

The POB also recommends that the Independent Person consider obtaining the assistance of Tucker Alan, as well as Messrs. Sullivan, Jaenicke, Fritz and Pearson, in conducting the Reviews and preparing the Reports.

D. <u>Confidentiality Agreement</u>

The POB believes that a confidentiality agreement should be entered into between the Firms and the Independent Person with regard to Firm information and documents to be submitted to the Independent Person for the Reviews.

The Firms provided the POB with a proposed confidentiality agreement on September 7, 2001. This proposed agreement, among other things, required that the POB not retain any documentation underlying the Reviews beyond the date of issuance of the POB's Reports, and that the POB not provide information about the Reviews to any third parties without the prior approval of the Firms. In a telephone conference on September 19th, POB counsel told counsel for the Firms that the proposed confidentiality agreement was not acceptable to the POB, and provided extensive comments on that agreement. These comments included, among others, that the POB should retain the documents underlying the POB's conclusions, recommendations and observations in the Reports for a reasonable period of time after issuance of the Reports, and not dispose of those documents at the time it issues the Reports. In addition, POB counsel stated that the POB should not be in the position of being unable to grant a request for information or documents from the United States Congress, the SEC, the GAO, or other governmental entities ("Governmental Entities"), without having to first obtain the approval of the Firms.

E. <u>Foreign-Associated Firms</u>

There have been extensive discussions among representatives of the POB, Firms and SEC staff concerning the issue of whether the Firms' foreign-associated firms should be included in the Reviews. The SEC Revised Draft Letter calls for the Reviews to cover these foreign-associated firms in a limited manner.

We note that at the above-mentioned meeting on January 9, 2002, POB representatives concurred with the chief executive officers of two of the Firms, as well as the Chair of the SECPS Executive Committee, that reviews of foreign-associated firms should be deferred until January 2003, when specific quality control provisions in the SEC independence rules become effective for those firms. Because of the importance of this issue, the POB believes there should then be a special review of foreign-associated firms, separate from the instant Reviews.

F. <u>Dates for Reviews</u>

The SEC Revised Draft Letter proposes an amendment to the Term Sheet which would change the "as of" date for the Reviews from January 1, 2001 to June 30, 2001 and the testing period from the six-months ended June 30, 2001 to the shorter period May 7 to June 30, 2001. The POB concurs with this change in view of the fact the SEC's new independence rules were not in effect on January 1, 2001, but, for the most part, were by May 7, 2001. At the above-mentioned meeting on January 9, 2002 with the chief executive officers of two of the Firms, as well as the Chair of the SECPS Executive Committee, POB representatives confirmed this view.

We also note that, consistent with comments given by POB counsel to the SEC staff on December 17 and 19, 2001, there should be flexibility for the Independent Person to test items outside of the designated time period, in order to obtain reasonable assurance that the Firms' Systems and Controls were operating effectively during the time period, to identify "best practices" or otherwise to achieve the purposes of the Reviews.

VIII. <u>Conclusion</u>

The POB believes that, consistent with the Term Sheet and the public interest, the Reviews should be performed, and the Reports issued, by an Independent Person in

the manner discussed above. In particular, it is the view of the POB that the Reports should be written in "plain English" with informative, meaningful and transparent disclosure, in furtherance of the public interest.

It is important that the Reviews and Reports be undertaken and completed as soon as reasonably possible. As stated in Mr. Morrissey's letter dated February 20, 2002, referred to above, any "protracted delay" in completing the Reviews and Reports "could undermine investor confidence in the audit process."

We note that Mr. Morrissey's February 20th letter requests that the Firms develop "an alternative approach" for completing the Reviews and Reports for consideration by the SEC staff. The POB believes that this request is not in the best interest of the Firms or the public, or in the spirit of the Term Sheet. An approach for the Reviews developed by the Firms themselves could be subject to criticism as lacking independence and thus credibility. Accordingly, we believe it is in the public interest, as well as consistent with the Term Sheet, for the Reviews and Reports to be developed by an Independent Person.

Sincerely,

Charles A. Bowsher

Charles A. Bowsher
Chair

cc: Robert K. Herdman
Chief Accountant
United States Securities and Exchange Commission

Charles D. Niemeier, Esq.
Chief Accountant
Division of Enforcement
United States Securities and Exchange Commission

Robert W. Gramling
Consultant
United States General Accounting Office

Michael A. Conway
KPMG LLP

Edmund Coulson
Ernst & Young LLP

Michael O. Gagnon
PricewaterhouseCoopers LLP

Charles A. Horstmann
Andersen Worldwide

[1] The SEC informed the POB that, after the Term Sheet was entered into by the SEC and the Big 5 Firms, the next three largest firms (BDO Seidman LLP, Grant Thornton LLP, and McGladrey & Pullen LLP) volunteered to participate in the Reviews. The POB was advised subsequently that these three firms may not participate in the Reviews.

[2] See "Accounting Industry Oversight Board Votes to Disband to Protest SEC Plans" at page A2 of the January 23, 2002 issue of *The Wall Street Journal*, and "SEC Chief Pushes Accounting Agenda" at page C1 of the January 24, 2002 issue of the *Los*

Angeles Times.

[3] In a subsequent letter to SEC Chair Pitt dated January 31, 2002, I stated that, after having given serious consideration to the matters discussed with Chair Pitt and the content of his letter of January 22, 2002, and having consulted with the leadership of the AICPA and the Chair of the SECPS Executive Committee, the POB believed it would not serve the public interest for it to continue. In particular, I said, "Given the recent events and the SEC's proposal for a new structure, we believe that we cannot effectively oversee the activities of the accounting profession and it would mislead the public to seem to do so."

[4] As previously noted, POB counsel provided extensive comments on the SEC Revised Draft Letter to the SEC staff on December 17 and 19, 2001. While the POB believes that all these comments have merit, in the interest of keeping the discussion in this letter relatively brief, only some of the comments are discussed here.

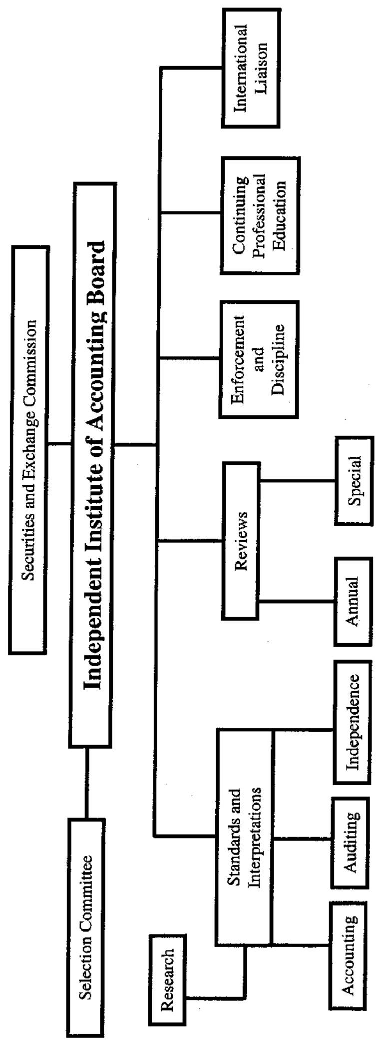
[5] See note 4.

Resolution Passed by the
Public Oversight Board on January 20, 2002

Be it resolved, after due consideration of the importance of effective self-regulation as one aspect of the oversight of the accounting profession, but with recognition of the obstacles to achieving this goal which have been encountered in recent years, and given the proposal of the SEC in consultation with the AICPA and the SEC Practice Section Executive Committee, without input from the Public Oversight Board, to reorganize the self-regulatory structure, the POB intends to terminate its existence pursuant to Section IX of the POB Charter no later than March 31, 2002.

The March 31 date is selected to provide time needed for coordination with the SEC Practice Section and for transitioning important tasks now underway, such as monitoring the implementation of the recommendations of the Panel on Audit Effectiveness; overseeing the Auditing Standards Board, the SEC Practice Section, the Peer Review Committee and the Quality Control Inquiry Committee; conducting the special independence reviews of the Big 5 accounting firms; and, based upon the POB's more than 20 years' experience, offering suggestions as to how the existing self-regulatory structure, now rendered largely ineffectual, might be substantially strengthened. The members of the POB believe that its professional staff can be a continuing resource beyond March 31 in assisting in the creation of a new and effective self-regulatory regime.

APPENDIX C


Securities and Exchange Commission
Independent Institute of Accounting Board
Selection Committee
Research
Standards and Interpretations
Accounting
Auditing
Independence
Reviews
Annual
Special
Enforcement and Discipline
Continuing Professional Education
International Liaison

PREPARED STATEMENT OF AULANA L. PETERS

MEMBER, PUBLIC OVERSIGHT BOARD
RETIRED PARTNER, GIBSON, DUNN & CRUTCHER
FORMER COMMISSIONER, U.S. SECURITIES AND EXCHANGE COMMISSION

MARCH 19, 2002

Good morning, Mr. Chairman. Thank you for giving me this opportunity to share my views on the issue of reform of the accounting profession's self-regulatory structure. In a conversation I had with the Robert Herdman, Chief Accountant of the SEC last January, he commented that there are times when reform can and should be evolutionary and times when it must be radical. Based on my oversight experiences as a member of the POB, I had begun to conclude that the profession's self-regulatory structure needed reform and was looking forward to working with the profession and within the structure of the POB to develop those reforms. But the crisis precipitated by the Enron scandal and other events have created an environment of urgency. So, here we are. The Chief Accountant did not tell me whether he thought the times called for evolutionary change or radical change. In my view, the current state of affairs requires the change to be radical and immediate.

Before proceeding with my testimony, I wish to emphasize that the views I am about to express are based on my observations and conclusions about flaws in the current self-regulatory process. I believe these flaws are inherent in the structure itself and are not the result of any lack of competence of the professionals who serve as members of the Auditing Standards Board (ASB), the Quality Control Inquiry Committee (QCIC) or the Peer Review Committee of the SEC Practice Section of the American Institute of Certified Public Accountants (SECPS). During the past year, I have observed dozens of accounting and auditing professionals devote countless hours and enormous energy to setting standards, investigating alleged audit failures, and conducting peer reviews. The individuals involved in these processes are, without a doubt, highly intelligent, undeniably expert and extraordinarily dedicated. These men and women are not compensated for contributing their talents and skills to the work of the various committees of the American Institute of Public Certified Accounts (AICPA). Their reward is the satisfaction of knowing that their efforts are directed at improving the financial reporting process.

General Structure

Chairman Bowsher has summarized for you the most important points of the self-regulatory structure the POB believes is the most appropriate model for the accounting profession. It achieves the streamlining of what commentators like to call the "alphabet soup" of governance, by bringing all standard setting under one roof, eliminating overlapping and untimely disciplinary procedures, and by strengthening and adding transparency to what was the peer review process.

Based on my observations and experiences, I have concluded that it is critical for the power of any new self-regulatory structure to be based in legislation. This is essential for the independence, certainty and long-term viability of whatever entity is created. For example, without a legislatively-based source of authority and funding, the new regulatory entity would be vulnerable to pressure from the persons it regulates or who are directly affected by its regulation.

Furthermore, I believe that streamlining the current governance system is not likely to be accomplished through negotiation and compromise. For example, the SEC proposal is just such a negotiated compromise and I am advised that it leaves standard setting and the discipline of "smaller" firms with the AICPA. Furthermore, it does not deal with the Financial Accounting Standards Board. Consolidating all self-regulatory activities under one umbrella regardless of vested interests is important for efficiency, effectiveness, and cost savings.

Most importantly, any new self-regulatory structure must be completely independent of the profession. In my opinion it is not enough to create an entity in which the public members "predominate," whether by a simple or super majority. No member of the new "board" or "institute" or "panel" should be affiliated with or responsible to any accounting firm or the AICPA. That does not mean that the self-regulatory process should not tap the talent and expertise of the profession. There are other ways to achieve that end. For example, retired leaders from the accounting profession such as Michael Cook, Shaun O'Malley, or Robert Mednick, just to mention a few, could be called upon to serve. In addition, former chief executive officers, chief financial officers, and well-known and respected institutional money managers would contribute vital input to the process from the perspective of preparers and users of financial statements.

The Structural Changes

From the public's perspective, I think that one of the most important aspects of the new self-regulatory process will be that which is focused on discipline. To the extent the discipline can be structured to have a diagnostic element, as well as a punitive/remedial one, both the accounting profession and the public will benefit.

Quality Control

The objective of the peer review process is to evaluate the design of and test compliance with a firm's quality control system with a view to determining whether there are weaknesses, deficiencies or other problems within the system that would likely contribute to or result in substandard audits. However, I believe that peer review is not, as currently structured, a good diagnostic tool for reviewing the quality control system with a view to detecting and remedying flaws that result in a particular substandard audit. Furthermore, the peer review process is not predictive in that it has not been an effective tool for identifying how and why auditors in the field make bad judgment calls.

I think the POB's recommendation that the triennial peer review be replaced by a retooled annual review conducted by the new regulatory agency will make the review process a more useful diagnostic tool even though it is unlikely that it can be more predictive. In my view, regardless of whether a review is triennial or annual, it will not prevent future audit failures although it can be enhanced to better serve its purpose of quality control. The POB proposal calls for the process to become:

- Independent of and from the firm being reviewed by transferring the activity to the self-regulator. This change may enhance scrutiny of quality control by avoiding potential biases in a system where competitors, having possible incentives to not burden the system with additional obligations or otherwise act to their own detriment, perform the review.
- Applicable to all engagements selected through the sampling process with no engagement being excluded from the review simply because it is, or possibly could be, the subject of litigation. Such engagements provide an opportunity to examine challenged audits to test compliance with quality controls and receive timely information on what went wrong with the quality control system and therefore could help avoid future audit failures.
- More transparent in that the reports issued include a description of (1) the limitations of the review and (2) the findings (whether "best practices" or "deficiencies") by the reviewing team.

Discipline

The current QCIC process is designed to review cases that are the subject of litigation to determine if there is a systemic problem at a firm whose audits become the subject of litigation. If during the course of this review the committee finds a problem with an individual's performance on the specific audit, it may refer the matter to the Professional Ethics Executive Committee (PEEC) and recommend action to be taken by the firm with respect to the specific individual. In my view, the QCIC and PEEC processes are flawed because they are segregated from one another and thus are not geared to react quickly to bad judgment calls that do not signal a breach of the quality control system; they are structured to have no impact on pending litigation which weakens the diagnostic or remedial benefits of their actions; and their ability to gather facts is limited.

The POB recommendations address these issues by combining the QCIC and PEEC processes into a single disciplinary system for all auditors, so that issues of quality control are not divorced from those of individual performance. The new regulatory entity will be responsible for both identifying problems and remedying them. It will also conduct the annual reviews; consequently the information gleaned and lessons learned should naturally feed back into the standard setting process on a timely basis.

The POB, as does the SEC, recommends that the new regulatory body have the power to compel the production of documents and take testimony, thus giving it authority to investigate fully allegations of audit failure or accountant malfeasance. Greater access to information should facilitate a deeper probing of the possible causes of alleged audit failures. However, the POB's proposal differs from that of the SEC in that it provides for no deferral process. This difference is important because the POB model goes farther in assuring the public that the disciplinary process is working and that errant accountants are being held accountable.

POB Termination

Finally, I would like to comment on the question of why the POB voted to disband and reiterate the particular facts that motivated me to vote with my colleagues. For me the key facts are:

On December 4, 2001, the POB learned, after the fact, that the Chairman of the SEC had met with representatives of the AICPA and the "Big 5" to discuss the implications of the Enron disclosures for the profession and its self-regulatory structure.

On January 4, 2002, the POB attended a meeting of the Executive Committee of the SEC Practice Section at which it learned from a committee member that the AICPA had formed a working group to formulate a proposal for a new self-regulatory structure to submit to the SEC. Comments were made to suggest that an announcement of the plan was anticipated within a few weeks. This was the first time that the POB was advised of the existence of this task force and its work. The POB immediately asked to be included in and advised of the progress of the working group's activities as part of its oversight duties.

On January 17, 2002, the POB was informed for the first time that that morning the Chairman of the SEC would hold a press conference to announce his plans for changes to the accounting profession's self-regulatory system. Subsequently, but prior to finalizing its decision to disband, the POB learned that AICPA working group had submitted its proposal to the SEC a week prior to the January 17 press conference.

Thus, the POB the independent body charged with oversight of the accounting profession and in that regard assigned the duty to act in the public interest was effectively excluded from a process of great moment for the profession and the public it serves. I for one am not concerned about whether the exclusion was intentional or the unintended result of bad timing. Regardless of "why," circumstances were created in which the POB could not effectively perform its oversight duties. The POB cannot be the public's eyes and ears in an informational vacuum. Furthermore, the POB is a creature that exists at the sufferance of the SEC and the accounting profession. Consequently, whatever authority attaches to its activities and recommendations is based on a consensus of the SEC and profession. that the views of the POB are relevant and of significance. Thus, being excluded from a process which Chairman Pitt reportedly described as producing "unprecedented" change for the accounting profession clearly signaled the POB's perceived irrelevancy and emphatically undercut its authority and legitimacy.

Thank you for your time and patience. I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF JOHN C. WHITEHEAD

FORMER CO-CHAIRMAN, GOLDMAN SACHS & CO.
FORMER DEPUTY SECRETARY OF STATE

MARCH 19, 2002

I am honored to appear before you this morning as I have done a number of times in the past: First back in the early 1970's as Chairman of an SEC landmark study of the effect of institutional investors on securities markets, later as Chairman of the Securities Industry Association and also as Co-Chairman of Goldman Sachs on various matters, still later as Deputy Secretary of State and again on one occasion as Chairman of the Federal Reserve Bank of New York. I appear today, however, as a former nonmanagement director and audit committee chairman of more than a dozen public companies, not all of them, I assure you, at the same time.

I have always championed the importance of our securities markets and the competitive structure of the institutions that serve them. They are a national asset and an important part of our leadership position in the world economy. The confidence that investors have in the system must be protected at all costs. I have also championed the importance of diligent independent nonmanagement directors who represent the stockholders effectively and the public interest.

The Enron disaster is a severe blot on the generally good record that the system has had over the years. Indeed, it is an embarrassment to those of us who have been involved in that system. It is still hard for me to believe that what was coming to be considered one of America's great companies could collapse so rapidly in such an ignominious way, with such huge losses to employees, to lenders, to stockholders, and to the reputations of everyone involved: The management, the board, the audit committee, the auditors, the bankers, the security analysts, and the customers. It

would seem to me that grounds for criticism exist in many places and that a thorough public review and investigation, including these hearings, is absolutely desirable and necessary. I am knowledgeable enough about the system, however, to be quite confident that most companies act responsibly and that there are not a lot of Enrons out there.

The only good result of the collapse is that it is causing companies now to look closely at their practices and at their disclosure policies, causing boards to review their attitudes, causing auditors to be more independent and more thorough, lenders to be more careful, security analysts to be more thorough, etc. I can assure the Committee that there is now a self-cleansing process going on out there which is very healthy. It might be fruitful for the hearings to begin to focus not only on what actually happened to Enron but on what the various institutions are doing now to keep it from happening again somewhere else. It may be wise to let this self-cleansing process go on for a while without being too precipitate with legislative action.

It is clear to me that there were many signs that a more alert or even a more curious board might have recognized as fair grounds for questioning. Certainly any request to the Board to waive the Board's ethics rules to exempt a transaction that otherwise would have violated them should have been enough to bring a lot of questions. However, the Committee should realize that it is very difficult these days to find and successfully recruit good board members. Many top experienced executives who would make excellent nonmanagement directors feel that their hands are full handling their present job, that their lives are already too full of other responsibilities and that the doubtful prestige and unimportant extra compensation from taking on one or two outside directorships is not worth the increasing legal risks and the necessary time commitments. It would be a very unfortunate result of the Enron disaster if it became impossible now to recruit to board membership the kind of experienced, capable people that the system increasingly requires. The Committee should be careful about unnecessarily increasing the financial risks and the time commitments of nonmanagement corporate directors.

Having said that, I do believe some things can and should be done now.

1. Having given the matter a lot of thought in recent years, particularly when I was Co-Chairman with Ira Millstein (who testified before you a few weeks ago) of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, I have reached the conclusion that the accounting firm that does the audit should not do other advisory work for the company. Without that, the independence of the auditors work will always be suspect. I reach that decision reluctantly but I do not see that it is possible now to restore public confidence in the independence of the auditors without it. The auditing firms should understand that this certainly does not require them to spin off or close down their advisory services. They would still be free to do advisory business with any company, excepting those they audit. Thus for any one firm what business they lose to others could be offset by business that others would lose to them, with no loss to the industry as a whole. As an alternative way of accomplishing the same purpose, it might be worth considering whether the restriction might be placed on the company rather than on the auditors by requiring that a public company should not employ their auditing firms for services other than the audit. It would be preferable if this all could be accomplished by SEC action or action of the exchanges rather than by legislation. Of course, it might be appropriate to except from the rule fees for minimal advisory business and in any case a reasonable phase-out period should be allowed.

2. An unfortunate practice has developed in the relationships between management, auditors, and board audit committees on the setting of auditor's fees. Fees are set annually by negotiation between management and the auditor and then approved by the audit committee. Managements objective, as it is with all expenses, is to keep the fees as low as possible. The auditor, at that stage, has no idea of how much time it will take, or how much extra work might be required to complete the audit and is often pressured to accept a lower fee and agree to a shorter time schedule than might be necessary in case questions arose. Audit committees often agree to the fee and the time schedule, unwilling to question what seems reasonable in relation to last year. If the auditor later does find questionable practices, he may have neither time nor money to pursue them under the terms of his agreement. A better practice would be to allow the auditor, at his option, to do work and charge fees up to a limit of, say, twice the original fee. This would tend to make management more aware of the authority of an independent auditor.

3. Over the years accounting rules, something like the income tax code, have become increasingly complex and arcane with the result that in combination they can often obfuscate the simple facts and obscure full disclosure. Rules that permit these results, such as hiding off balance sheet debt, transactions with related parties, alternative accounting for acquisitions, etc., evade the principle of full disclosure and

undermine the foundation stone of our free market system. The National Accounting Standards Board should be asked to review these matters promptly and recommend appropriate changes in the interest of full disclosure.

4. Rules now require that the chairman of a public company's audit committee have considerable financial background and experience. Those rules should be amended to require *all* members of the audit committee to have such backgrounds. This will encourage the recruitment to the board of more experienced and qualified people and the recruitment to the audit committee those with the most financial experience.

5. Since the principal purpose of audits is to provide public information to investors and the financial community, I believe the self-regulating authority of the SEC over the securities industry and the stock exchanges should be extended to the auditing firms. This would be an important addition to the present self-inspection system of the auditing companies. The authority of the SEC should also be extended to create a new self-regulatory entity charged with drafting a voluntary code of best corporate governance practices linked to an SEC disclosure requirement. Companies would then disclose whether they comply with the voluntary code, and explain areas of noncompliance.

PREPARED STATEMENT OF L. WILLIAM SEIDMAN

FORMER CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

FORMER CHAIRMAN, RESOLUTION TRUST CORPORATION

MARCH 19, 2002

Mr. Chairman and Members of the Committee: I am pleased to be invited here to add my thoughts on Enron to the many outstanding presentations you have already received, including my distinguished friend Chuck Bowsher.

My experience that may be relevant to the questions raised by Enron's disastrous failure include:

- Chairman of an international accounting firm in *troubled* times.
- Chief Financial Officer of a major international copper producer in *troubled* times.
- Dean of a major Business School in *troubled* times.
- Chairman of the FDIC and the RTC in very *troubled* times.
- Chief Business Commentator on CNBC 10 years in both good and *troubled* times.

There is no doubt that Enron's failure has created troubled times for the accounting profession and securities markets looking for the causes of failure and its accompanying financial losses, as this Committee knows is not a simple task. The changes that are needed to try to avoid such costly events in the future will be numerous and unfortunately complicated.

I believe we still have more to learn about Enron (and related activities), but it seems more clear each day, that Enron failed because it held itself out to be a trading company designed to hedge risk and make profits on trading, when, in fact, it turned out to be a company taking huge risks speculating in many volatile markets, including some that it was pioneering. When the market prices moved against the exposed underlying position, the company failed. Not as has been stated, because of a bank run, but because of huge losses that finally became visible. Enron's hedges proved to be ineffective because they were with Enron's "other pocket" related companies for which Enron was ultimately financially responsible. Further, the profits were reported on a market-to-market basis for future contracts for which there was no real market. Thus profit was dependent on future market prices determined by the company as the largest "market maker" in the field. Using optimistic forecasts, the company was anticipating earning profits based on estimates of future prices, when, in fact, these were not determinable. While accounting rules require market-to-market, there has to be a market for them to apply.

The free market has now exercised its will and "regulated" Enron, as it always will, but the unrestricted free market is often a brutal and costly regulator. What can be done to avoid or minimize this kind of debacle in the future?

I would suggest examination of three areas in need of some reform:

- Accounting policy and governance.
- Corporate governance.
- Government's regulatory, tax, and supervisory role.

Accounting Matters

From what we know at this stage, it seems that the CPA audit reports did not really "fairly present" the position of the company in a way that was understandable by investors, even sophisticated ones. Further, the accounting standards, though possibly technically followed, did not result in information adequate for markets to make decisions. Enron was a very complex large company and thus it was difficult to understand its operation, but the accountants did not make it easier.

Both accounting standards and the firm applying them failed to provide the clear information necessary for free markets to perform effectively.

What to do:

1. The Government must provide and control the regulation of public accounting firms. Accountants start with a basic conflict of interest since they are paid by the enterprises they audit. Thus governmental control is necessary to insure compliance with the rules of operation. The alternative is for Government itself to audit, which is undesirable (though the Government does run the worlds largest "audit firm" (the IRS). Auditing is a highly competitive profession that needs structure for competition with compliance done by Government. This Government body should be appointed by the SEC Board. Its charge will be to insure that accountants follow the rules of practice as set by the SEC, FASB (or successor). The body should be bipartisan with terms of at least 4 years.

Many changes will follow from this, including, but not limited to, separating audit from consulting, control of the "swinging door" between audit firm personnel and client accounting positions and possible rotation of auditors. Incidentally, I do not believe that tax return preparation and advice should be a part of the consulting practice separated.

2. The accounting and auditing standards must be set by an independent body financed by independent sources—Government tax, user fee, etc. This organization must be protected from undue influence both of a public and private nature much like the FDIC and RTC was during my tenure as Chairman. The FASB seems to have performed reasonably well, except where outside pressures forced them to abandon necessary action.

Corporate Governance

The Board

It is far from clear what the failure of corporate governance was at Enron. The Board relied upon reputable independent CPA's and legal counsel, and on a management perceived to be of the highest reputation. Even their doubtful approval of a conflict of interest regarding related parties transactions were set up with care. The audit committee's independence perhaps is in question, but there are already many independence rules in place on that issue. We must take care not to unfairly burden directors and particularly audit committee members or the result will be to reduce the availability of good directors to serve.

If the directors failed in their fiduciary duties, the courts will hold them accountable. While insurance may cover their liabilities, they cannot be assured of this result if their conduct violates their fiduciary duties. I would suggest only two substantive changes be considered.

First, my experience as a member of boards suggest that allowing one person to be the Board Chairman and CEO concentrates too much power in one place. While this is the way most U.S. boards of directors are organized, it can result in real abuse when the wrong person is CEO.

Second, in this regard, it is important that the independent director (or some of them) constitute the committee to recommend new and retained directors to the board for approval. This suggestion will support board independence on which the governance system is based.

The Corporate Offices

Corporate officers performed poorly (to say the least) at Enron, but it is difficult to set performance standards legislatively. At the FDIC, we recommended, and the Congress passed, laws preventing golden parachutes when used shortly before a company failed. This was a difficult law to draft and enforce. Today, the golden parachute is offered in the form of options exercised while the officer knew or should have known the company was in trouble. Today's laws allow reclaiming profits, but this is not punitive. I guess most taxpayers would say, "do something," but do not create more lawsuits so perhaps a penalty is justified.

Government Regulation, Supervision, and Taxation

In my view, free markets usually work better when Government has set the structure for them to perform. That is why we have an SEC, FDIC, Federal Reserve,

OCC, EPA, CFTC, Anti-Trust Division, and many other agencies. Each came into being to remedy a market failure in the past.

A good free market operates like a *prizefight,* plenty of chance to slug it out, but not below the waist and not with the second's stool. An unrestricted market is like a *ballroom brawl* where the fight results in wide spread destruction of both people and the place, and the winner may be the dirtiest fighter on the scene.

The trick, of course, is to have the right rules that promote fair competition without stopping the competition.

Enron tells us the structure for unregulated futures markets and derivatives failed and a market structure, while difficult to construct, is needed. Enron was a brawl because no regulators were empowered to deal with a good part of their market behavior. This supervision will be complicated to create, but only slightly more so than other supervision such as commodities futures, banking, antitrust, etc.

Further, the tax system, which allowed Enron to avoid tax liability while reporting large profits, also must be fixed. The loss of revenue through Enron-type activities is growing rapidly. Tax results can be improved by enhancing IRS capabilities, including the use of private sector professionals and better tax laws.

Above all, Enron's markets and activities needed transparency—a job that can only be done appropriately by the Government agency—the SEC.

I have not tried, in this short period, to deal with all the many suggested actions in Congressional bills, testimonies, and the administrative proposals. I will be pleased to answer questions where I can on these and other matters.

In summary, there is much to be done by the Congress, to reduce the chances of "another Enron," but it must keep in mind that *overreaction* can do as much harm as no action at all.

Thank you.

PREPARED STATEMENT OF MICHAEL MAYO

MANAGING DIRECTOR, PRUDENTIAL SECURITIES, INC.

MARCH 19, 2002

Chairman Sarbanes, Senator Gramm, Members of the Committee, thank you for inviting me to testify today about conflicts on Wall Street. I will cover conflicts among brokerage firms, corporations, and research analysts. I currently work for Prudential Securities, which values independent research, however, I am here today to give my own personal point of view.

It is great to be back near my home in Maryland. I hope that the University of Maryland basketball team advances far in the NCAA basketball tournament. I can guess that the Chairman shares my hopes.

I am here to talk about what can be analogous to playing basketball with one hand behind your back. Objective analysts, those with negative opinions and/or critical remarks, may have trouble holding corporations accountable. The reason is that companies themselves and their managements are the best source of information, and bullish and conflicted analysts may have the best access to this information.

It is still hard for an analyst to be objective and critical. When an analyst says "Sell," there can be backlash from investors who own the stock, from the company being scrutinized, and even from individuals inside the analyst's firm. While much attention in Washington is being paid to the pressures related to a firm's investment banking operations, other pressures can be as great or more. The main point: Some companies may intimidate analysts into being bullish. Those who stand up may face less access to company information and perhaps backlashes, too.

I have a few perspectives to support my view:

- From personal experience: I have worked at 4 of the 10 largest brokerage firms. I understand how the brokerage industry works.
- From my research: I have covered the banking industry since the late 1980's and head the financial research group at Prudential Securities.
- From my stock ratings: When the facts support it, I do not shy away from placing Sell ratings on companies I cover. I have probably done so more than almost any other analyst.
- From my current firm Prudential Securities: A year ago, Prudential shed almost all of its investment banking activities.

I will cover three areas in my testimony: (1) My personal experiences; (2) The conflict between serving investors versus corporations; (3) Problems with access by research analysts to corporations.

My Experiences

As I prepared for my career, I had all the usual training—financial textbooks, MBA training, professional certification, and even training at the Federal Reserve here in Washington. But playing-by-the-book does not do it on Wall Street. Here are a few personal examples to illustrate my point.

- After publishing a report with a Hold rating—not a Sell but a Hold rating—the CFO of the subject company had a shouting match with my boss and me. There was a threat of investment banking business getting withdrawn. Luckily, my senior management supported me.
- I published a report criticizing a merger. One investment banker barked at me, "How do we make money off this research?" I stuck with my opinion.
- A bank excluded me from an important dinner meeting at which all of the other banking analysts from major firms were in attendance.
- A CEO called to complain. He did not like negative comments in a report. He said that he gave investment banking business to my firm due solely to me. He said we had "let him down." I said simply that we are objective with our analysis.
- I placed a Sell rating on one bank. I was told that the bank's management, in turn, told large investors that we had not done our homework, effectively criticizing our research approach. Within 6 months, I was proven correct after the stock declined as a result of issues when earnings were publicized.
- We asked to visit with the management of a company. The response was "No." I finally took a meeting with one company representative. They had said, "Take it or leave it." What choice did I have?

So whether the time was the start of last decade or the start of this decade, whether the firm was UBS, Lehman, Credit Suisse First Boston, or Prudential Securities, the backlash from corporations was similar. Little has changed to help me perform my job better. This pervasiveness suggests there are larger issues at work. We need to address these issues to ensure that investors get unbiased research.

Conflicts At Brokerage Firms:
Between Serving Investors Versus Corporations

This statistic is critical: The brokerage industry earns four times as much from serving corporations (i.e., through investment banking and related services) as from serving investors. Two decades ago (1982), this ratio was one to one.[1] In addition, the same firms (the 10 largest brokerage firms) that get most of the trading business with investors gain an even greater percentage business of investment banking activities with corporations.

So who is really the client? The degree of conflict between serving corporations and investors—based on where the money is made—is at its highest level in history. If nothing else, this creates an environment ripe for abuse.

For brokerage firms, what does it mean to earn four times more from corporations? First, investment bankers have the leverage. They want research analysts to act as team players. To them, this may mean saying nice things about their major corporate clients or potential future clients. Second, brokerage firms hire people who get along with investment bankers. One manager who hired me said that, in evaluating analysts, the firm placed a lot of weight on what the companies had to say to investment bankers. Can you imagine? This is like judging a food critic based on what the restaurants say!

For analysts, what does it mean that their firms earn four times more from corporations? It means financial incentives, which can taint analysts' opinions, and keeping a job. Its not rocket science: Eighty percent of traditional brokerage profits come from corporations. Help the firm, you do well. Hurt the firm, why get rewarded? Analysts are mainly bullish and conflicted, probably because they do not want to lose their jobs.

My main point: People do what they are incented to do. For brokerage firms, the incentive to serve corporations over investors is stronger than at any other point in history. For analysts, the main incentive is to stay employed.

Problems With Access By Research Analysts To Corporations

It takes an objective and critical analyst many times more work to do the job than it does a bullish or conflicted analyst. The main reason: Backlash from corporations. Such backlash can take various forms—I have five examples:

[1] Based on revenue data from the Securities Industry Association from 1999–2001 and assumed profit margins, earnings (pretax) in investor businesses were $35 billion versus $127 billion from investment banking. In comparison, these amounts in 1982 were $2.1 billion and $2.6 billion, respectively.

(1) INVESTMENT BANKING: The influence of investment banking on stock research is well documented after the Internet bubble. Per my other examples, sometimes companies pull business from a company after a critical report.

(2) PHONE CALLS WITH THE COMPANY: Phone contact is part of analysts' day-to-day communication to get more color behind the numbers. Bullish and conflicted analysts can get their calls returned first, and even get senior executives on the line, including the CEO. As for objective and critical analysts, at times their calls are not even returned.

(3) MEETINGS WITH MANAGEMENT: Some firms reply to a meeting request, "Why is it a good use of our management's time?" In other words, "Say something positive, we will let you in."

(4) CONFERENCE CALLS: Companies hold conference calls for earnings, strategic moves, and other reasons. Conference call systems let you manipulate the order that questions are answered. Last year, on one call, the operator said my call was in the queue. I then hear, "No more questions." Do the more novice investors listening to the conference calls realize that the order of the questions can be manipulated?

(5) MANAGEMENTS PARTICIPATION IN ANALYST EVENTS: Institutional investors—my main clients—pay a lot of commissions if you hold good conferences and bring managements in to see them. Guess who gets these tasks? Bullish and conflicted analysts, especially those whose firms have investment banking relationships.

For the bullish or conflicted analyst, calls may be returned first, questions may be taken on conference calls, meetings with management may get scheduled earlier, managements help out to visit investors or participate in conferences, and investment banking fees may be better to boot.

Reg FD has not fixed all of the problems. Companies simply make canned presentations on a webcast, but then may choose to turn off the webcast during the Q&A and the follow-on breakout sessions. (Also, some firms do not webcast their presentations, which I find very discouraging.)

Perversely, this poor treatment has helped to make me and my team better analysts. We are forced to better scrutinize accounting footnotes, interact more with impartial third parties, and go out and "kick the tires."

In other words, we are forced to hustle a lot more. To use the analogy, we are still doing the equivalent of playing basketball with one hand behind our back. The issue: I am not sure how many analysts are willing to accept this handicap, especially the newer ones trying to pay their New York City rents.

To recap the problems: (1) From my perspective, it is business as usual when it comes to conflicts between companies and research analysts. (2) People do what they are incented to do. The financial incentives for brokerage firms to serve corporations has never been as high as they are today. (3) Objective or critical analysts continue to face backlashes in many ways.

So What Is The Solution? Information And Incentives

From my perspective, speaking solely as an independent analyst, there are a few steps that can be taken to improve the situation:

(1) INFORMATION: Make sure that the access to the information is fair. One idea: Have an avenue for those analysts who feel disadvantaged by the companies they cover to voice concerns and get corrective action. Maybe a clearinghouse whereby analysts have recourse to voice their concerns? Maybe someone at the SEC? Just give me someone whom I can call when I am treated unfairly. One caveat: Any solution needs to insure that companies still are incented to maintain the highest level of information flow. I do not believe we need to regulate analysts. Analysts need to have equal access to information and appropriate incentives to provide objective research. Let's address the root of the problem.

(2) INCENTIVES: Take actions to minimize the interference of investment bankers with the job of research analysts. Disclose investment banking relationships to investors. Does the retail investor know that the brokerage firm pitching shares is also earning investment banking fees from the company? A related solution is to eliminate deal-based incentive pay. Also, in terms of carrots and sticks, a lot of attention has focused on making the stick bigger to get the so-called "bad" analyst. The "carrot" needs more attention, to encourage good behavior. I know there is debate about separating research from investment banking. From my personal experience, I can tell you that this is an effective solution.

Conclusion

We have the best capital markets in the world. But let's not grade ourselves on a curve. They can be better. As analysts, we are at the intersection between the interests of corporations and the interests of investors. We provide institutional memory, act skeptically, challenge corporate authority, question assumptions, and

speak up if something does not smell right. We are on the front lines of holding corporations accountable. Prudential Securities scaled back its investment banking a year ago. The result is a great environment for me. I have 100 percent support of management when doing my research. Despite this, the pressures outside the firm are as strong as ever. The result: Impediments to conducting full, independent, unbiased investment research on corporations. Actions that can help remove these impediments and reduce the remaining conflicts will help improve our ability to serve clients . . . and when I talk about clients, I am talking about investors!

The Road to Reform

A White Paper From

The Public Oversight Board

On

Legislation to Create a New Private Sector

Regulatory Structure for the Accounting Profession

March 19, 2002

INTRODUCTION

On January 20, 2002, the Public Oversight Board (POB)—created in 1977 to oversee the voluntary self-regulatory structure for the accounting profession in the United States—voted to terminate its existence not later than March 31, 2002. For the POB, this action was taken as a matter of conscience and principle.

In a report prepared for the Senate Committee on Governmental Affairs in August 1980, the Securities and Exchange Commission (SEC) pointed out that for a self-regulatory program for the accounting profession to be successful, strong leadership from the POB is essential. The POB, wrote the SEC, "should serve as the conscience and critic of the self-regulatory effort." The POB's charter makes it clear that it is independent and the purpose of its oversight activities is "to represent the public interest on all matters that may affect public confidence in the integrity, reliability, and credibility of the audit process."

At the time the POB was created, there were concerns that it might not be the right solution. John C. Burton, a distinguished Professor of Accounting at Columbia University and the Chief Accountant at the SEC in 1977, warned in Congressional testimony in 1978 that "it is highly doubtful that a part-time group [POB] can either in fact or perception" provide an effective substitute for statutory regulation.

Meanwhile, Harold M. Williams, who was Chairman of the SEC at the time the current self-regulatory system was being created in the late 1970's, warned in a speech in January 1978, that "[t]he effectiveness and credibility of the Public Oversight Board depends on its independence, including its willingness to be critical when called for and its ability to make public its conclusions, recommendations, and criticisms." Chairman Williams also made the point that an effective POB could only be effective "if it is not impeded in performing its functions and responsibilities."

Following its decision to terminate, the POB decided to prepare this paper to outline its proposals to create a new regulatory structure for the accounting profession. These proposals stem from the POB's extensive experience with the profession's voluntary self-regulatory system, its knowledge of problems that confront that system, and its insights on the need for change. The primary purpose of this paper is to present the case for legislative action creating an independent regulatory organization in the private sector.

The POB felt it would be helpful to provide a brief history of how the current regulatory structure came into being; to discuss problems affecting the present regulatory structure; to provide the POB's views on enforcement, discipline, and several other issues facing the profession; and to discuss the POB's decision to terminate.

EXECUTIVE SUMMARY

Over the past 2 years, the POB has faced increasing obstacles that have impeded its ability to carry out its oversight functions. As a consequence, the POB feels it must perform its role as "conscience and critic" because events of recent months have demonstrated that the warnings of Dr. Burton and Chairman Williams have come to pass.

Three events are noteworthy in how the POB has been frustrated in its ability to effectively carry out its responsibilities.

- On May 3, 2000, the SEC Practice Section (SECPS)—an organization within the American Institute of Certified Public Accountants (AICPA)—took the unprecedented step of notifying the POB that it would refuse to pay for special reviews of public accounting firms. The special reviews in question had been sought by the SEC to determine whether the firms had complied with SEC and professional

independence standards. The decision of the SECPS to deny funding to the POB was a serious blow to independent oversight of the accounting profession. Melvin Laird, the former Congressman and Secretary of Defense, who served on the POB longer than any other member, said that this was "the worst incident in my 17 years" on the POB.

- Following the decision to cut off funding of the POB's special reviews requested by the SEC, the largest accounting firms—the Big 5—agreed with the SEC that the POB should instead conduct more limited independence reviews of the large firms. Despite this agreement, the next 21 months were marked by delay and lack of progress. The POB, in the end, was unable to conduct the reviews.
- For years, the POB had carried out its oversight responsibilities under a set of bylaws adopted after it was created in 1977. The POB felt that a formal charter would improve the independence of the Board, and a charter was one of the primary recommendations in 2000 of the Panel on Audit Effectiveness, created by the POB at the request of the SEC. However, objections from the AICPA and the Big 5 caused negotiations to drag on for more than a year. Ultimately, a new charter took effect in February 2001.

When the POB voted to terminate its existence, the lack of progress in connection with the independence reviews and the frustrations that stemmed from the funding cut off and slow negotiations over the new charter all played a role. But the precipitating factor was the decision of the SEC to develop a new regulatory structure in private talks with the AICPA and the Big 5 firms, with no consultation with the POB. The SEC did not consult with the POB even though the POB had been established by the AICPA, in consultation with the SEC, to protect the public interest.

When the POB initially learned of these talks, it asked to be included in the process and was promised that it would be consulted. That consultation never took place. In the end, the POB was simply informed—on the day of the announcement of the proposed new structure that there was no continued role for the POB in this structure, rendering it a "lame duck." The POB determined that it could not effectively oversee the activities of the accounting profession under the circumstances, and that it would mislead the public to appear to do so. Furthermore, the POB was concerned that if it were to continue during an interim period before a new governance structure was in place, it would leave the impression that the POB approved of the SEC proposal, which it did not. Thus, as a matter if principle, it voted to terminate its existence.

The Public Oversight Board strongly believes that a new regulatory structure for the accounting profession is essential and that, to be effective, it must be based on the foundation of Federal legislation.

The Board recommends that Congress create a new Independent Institute of Accountancy—the IIA—and center all regulation under its auspices. A seven-member board would run the Institute totally independent of the AICPA, the Big 5, and other firms. The chair and vice chair would be full-time employees of the Institute; five other members would serve on a part-time basis. All would be appointed by a panel composed of the Chair of the SEC, the Chair of the Federal Reserve Board and the Secretary of the Treasury. Once named, the chair of the IIA would join these three in naming other members of the board. Members of the IIA board could be removed only by a two-thirds vote of the board itself.

The SEC would have oversight of the IIA, and the SEC's Office of the Chief Accountant would be the liaison to the IIA.

Important functions of the Institute would include:

- The IIA would exercise oversight for all standard setting for accounting, auditing, and independence, and their interpretation. Accounting standards are just as important as auditing and independence standards. For this reason, the POB believes the Financial Accounting Standards Board (FASB) should be brought under the umbrella of the IIA, which would take responsibility for its oversight and funding.
- Firm-on-firm peer review would be discontinued for firms that audit more than 100 public corporations each year. In its place, IIA employees would conduct comprehensive and thorough yearly reviews of the annual internal inspections of such firms. Unlike peer review, no activities of a firm would be off limits to Institute reviewers and the process would produce informative public reports. Substantial staff resources to conduct these reviews will be needed.

  In addition to the reviews, IIA employees would conduct special reviews, when warranted. Similar to those the SEC originally asked the POB to undertake, these reviews would take a systemic, in-depth look at a firm's systems, policies, procedures, and operations. If necessary, such special reviews would delve into ques-

tions affecting the firm's compliance with applicable professional standards. As with the yearly reviews, reports of these special reviews would be public.

- An Office of Enforcement and Discipline within the IIA would have full authority to investigate allegations of wrongdoing by public accounting firms and their personnel. The POB recommends giving the IIA the privilege of confidentiality, as well as the power of subpoena to compel testimony and produce documents. Cases of alleged misconduct could be brought before hearing examiners. When warranted, these examiners could recommend to the IIA board the imposition of sanctions, ranging from fines to expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, State boards of accountancy, or other agencies, as appropriate.
- Funding would be provided through fees imposed on public corporations in amounts sufficient to cover the costs of the Institute. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May 2000.
- The IIA would be charged with coordinating international liaison and overseeing continued professional education for those in the profession.

Beyond these functions, the POB recommends that:

- With regard to nonaudit services for audit clients, the POB recognizes that there has been disagreement on restricting scope of services and that various models have been suggested for what should be allowed and what should be excluded.

  The POB strongly agrees with a point made in President Bush's 10-point reform plan that "Investors should have complete confidence in the independence and integrity of companies' auditors." The specifics on the President's plan recognize the importance of prohibiting certain nonaudit services in order to safeguard auditor independence.

  The POB takes note of a statement issued by the AICPA on February 1, 2002, in which it affirmed that it "will not oppose Federal legislation restricting the scope of services that accountants may provide their public audit clients, specifically in information technology and internal audit design and implementation."

  Against this background, the POB proposes that SEC regulations concerning independence be legislatively codified with appropriate revisions to update restrictions on scope of services involving information technology and internal audit services as noted above. At the same time, the POB believes such legislation should affirm that tax work not involving advocacy and attest work by audit firms in connection with SEC registration and other SEC filings be allowed. The POB also believes that small public businesses, to be defined by the SEC, should not be subject to any restriction on nonaudit services for audit clients. Further, with respect to nonpublic corporations, it is the POB's position that such corporations and the accounting firms that audit them should not be subject to any restriction on nonaudit services. We expressly emphasize this to avoid misunderstanding and any consequences to small business and small audit firms.

  The IIA Office of Standards should be empowered by legislation to promulgate appropriate rules affecting independence to cover changing circumstances.

  The POB believes there should be no prohibition against an audit firm offering nonaudit services to nonaudit clients.
- Auditors should be rotated every 7 years. As a corollary, public corporations would be prohibited from firing auditors during their term of service unless such action is determined by the audit committee to be in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC.
- Engagement and other partners who are associated with an audit should be prohibited from taking employment with the affected firm until a 2 year "cooling off" period has expired.
- The Institute should expand on the recommendations of the recent Blue Ribbon Committee which made it clear that the external auditor should be accountable to a firm's board of directors and its audit committee and not to management. Specifically, the audit committee should take full responsibility for hiring, evaluating, and—if necessary—terminating an audit firm.
- To discourage conflicts of interest involving public corporations, Congress should amend the Securities Exchange Act of 1934 to require more meaningful and more timely disclosure of related party transactions among officers, directors, or other affiliated persons and the public corporation. Such disclosures should be made promptly in current reports, as well as in proxy statements filed with the SEC.

- Management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. The corporation's chief financial officer and chief executive officer should sign this attestation and the auditor should review it. An auditor's review and report on the effectiveness of internal controls would—as the General Accounting Office (GAO) found in a 1996 report—improve "the auditor's ability to provide more relevant and timely assurances on the quality of data beyond that contained in traditional financial statements and disclosures." Both the POB and the AICPA supported the recommendation when the GAO made it, but the SEC did not adopt it.

A BRIEF HISTORY OF SELF-REGULATION

The Stock Market Crash of 1929 and Its Aftermath

The 1929 crash revealed a general absence of accounting and auditing standards, thereby permitting public companies to report financial position and results of operations that sometimes bore little relation to economic reality. The crash and ensuing depression led to Congressional hearings, which in turn led to several pieces of reform legislation, beginning with the Securities Act of 1933 and the Securities Exchange Act of 1934. The Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act and Investment Advisers Act of 1940 followed. These Acts require, or permit the SEC to require, as the SEC summarized in 1994, "that financial statements filed with the Commission by public companies, investment companies, broker/dealers, public utilities, investment advisors, and others, be certified (or audited) by independent accountants."

Although audits of public corporations were common before the Federal Securities Acts of 1933 and 1934, they had not been required by statute. Beginning in April 1932, the New York Stock Exchange (NYSE) requested corporations applying for listing to agree to have their annual financial statements audited by independent accountants.

The 1929 market crash revealed improper accounting practices at large public companies that had become bankrupt. In 1939, the AICPA's Committee on Accounting Procedure issued the first Accounting Research Bulletin and the AICPA's Committee on Auditing Procedure issued the first Statement on Auditing Procedure. At present, accounting standards are issued by FASB, auditing standards are issued by the AICPA's Auditing Standards Board (ASB), and interpretations of the Code of Professional Conduct are issued by the AICPA's Professional Ethics Executive Committee—all of which are private sector bodies.

The 1970's—Expansion of the Regulatory Structure

The major reforms of the 1930's and the regulatory system they created survived for more than 40 years with only minor modifications. That the regulation of the accounting profession remained unchanged for so long may be attributed in part to the relatively few allegations of audit failures during most of that period, at least in comparison with later years.

To this day, the responsibility for promulgating auditing and ethical standards resides within the AICPA. The AICPA also was responsible for promulgating accounting standards until mid-1973 through its Committee on Accounting Procedure and its successor body, the Accounting Principles Board. Both of those committees were comprised principally of practicing auditors, often those who were responsible for their firms' accounting policies. In 1973, responsibility for promulgating accounting standards passed to FASB in the belief that the setting of accounting standards by an independent body with no ties to either auditors or preparers of financial statements would enhance the public's confidence in the financial reporting process. At the same time, the Financial Accounting Foundation was created to raise funds for FASB, among other tasks, and a Financial Accounting Standards Advisory Council was created to advise FASB on its agenda and deliberations. That structure remains largely unchanged today.

A series of cases involving alleged audit failures in the 1970's led the AICPA to create the Commission on Auditors' Responsibilities, Chaired by Manuel F. Cohen, a former Chairman of the SEC. Those cases involved fraudulent financial reporting and illegal or questionable corporate acts, such as bribes, political payoffs, and kickbacks. The Cohen Commission's *Report, Conclusions, and Recommendations* issued in 1978 made numerous recommendations to improve audit practice in several areas. Those recommendations led to the promulgation of Statements on Auditing Standards (SAS) that increased the auditor's responsibility to detect and report fraudulent financial reporting and illegal acts by corporate management. Several other auditing standards can be traced either to the Cohen Commission recommendations or to specific audit failures and the litigation that they spawned.

The same cases that spawned the Cohen Commission also led to hearings by both the Senate and House of Representatives in 1977 and 1978. In particular, the Senate's Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations (the Metcalf subcommittee) held hearings to determine whether additional governmental regulation of the accounting profession was necessary or a system of professional self-regulation was sufficient.

In response to these hearings, the AICPA, in consultation with the SEC, created a voluntary self-regulatory framework consisting of the SEC Practice Section (SECPS) of the Division for CPA Firms, with an independent POB to oversee the activities of the Practice Section and to monitor and comment on matters that affect the public interest in the integrity of the audit process—a structure that exists to this day. While no additional governmental regulation was imposed once the voluntary self-regulatory system was created in the 1970's, the Congress did pass the Foreign Corrupt Practices Act (FCPA) in 1977, following Senate hearings which revealed the payment of bribes by American corporations to foreign officials. The FCPA made it clear that bribery of foreign officials by American companies is an unacceptable and illegal practice. The Act required SEC registrants to maintain a system of internal accounting controls to provide reasonable assurance that certain objectives would be achieved. For example, transactions must be executed consistent with management authorization and be recorded to permit preparation of financial statements in conformity with Generally Accepted Accounting Principles and to maintain accountability for assets. In addition, the FCPA required public corporations to make and keep books and records which, in reasonable detail, accurately and fairly reflect underlying transactions.

The 1980's and 1990's—Congressional Hearings and Legislation

As noted in a September 1996 report of the GAO, *The Accounting Profession—Major Issues: Progress and Concerns,* "In the 1980's, continued business failures, particularly those involving financial institutions, led to a series of Congressional hearings on auditing and financial reporting under the Federal securities laws." Two major pieces of legislation resulted from those hearings: The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and the Private Securities Litigation Reform Act of 1995. While those laws increased responsibilities for auditors, they did not address the regulatory structure of the accounting profession.

FDICIA added Section 36 to the Federal Deposit Insurance Act to provide early identification of needed improvement in financial management at banks and savings and loan institutions. Management's responsibilities under regulations implementing Section 36, which apply to institutions with total assets of $500 million or more, include reporting on management's responsibility for and assessment of the effectiveness of the institution's internal controls over financial reporting. Each institution is required to have an audit committee composed of outside directors independent of management. Audit committees of institutions with $3 billion or more in assets must include members with relevant banking or financial expertise, have access to their own outside counsel, and exclude large customers. Under Section 36, the independent accountant must examine and report on management's assertions about the institution's internal controls over financial reporting, using the AICPA attestation standards. This requirement constitutes one of the very few statutory or regulatory requirements that independent auditors report publicly on client internal controls.

The Private Securities Litigation Reform Act of 1995 addressed the concerns of Congress and regulators about auditors' responsibilities with respect to their clients' compliance with laws and regulations and about how instances of noncompliance were reported. Those concerns led to inclusion in the Act of a requirement that auditors of public companies notify the SEC of material illegal acts when an entity's management and board of directors have failed to take timely and appropriate remedial action.

The 1996 GAO report, which was commissioned by Representative John Dingell (D-Mich.), the Ranking Minority Member of the House Committee on Energy and Commerce, identified five major issues discussed in the various studies concerning the accounting profession from 1972 through 1995: (1) auditor independence, (2) auditor responsibilities for fraud and internal controls, (3) audit quality, (4) the accounting and auditing standard setting processes and the effectiveness of financial reporting, and (5) the role of the auditor in the further enhancement of financial reporting. The report summarized the results of these reviews as follows:

> GAO's analysis of the actions taken by the accounting profession in response to the major issues raised by the many studies from 1972 through 1995 shows that the profession has been responsive in making changes to improve financial reporting and auditing of public companies. Further,

> GAO's analysis of statistical data on the results of peer reviews of accounting firms that audit public companies registered with the SEC shows that most firms now have effective quality control programs to ensure adherence with professional standards. However, GAO's review of the studies' findings shows that the actions of the accounting profession have not been totally effective in resolving several major issues. Issues remain about auditor independence, auditor responsibility for detecting fraud and reporting on internal controls, public participation in standard setting, the timeliness and relevancy of accounting standards, and maintaining the independence of FASB.

While the profession and the SEC subsequently have addressed several of the issues that the GAO review identified as being unresolved in 1996, a number of them, such as reporting on internal controls, remain unresolved in 2002.

Changes in the Practice and Culture of Accounting Firms

The business model that describes the practice of the large accounting firms—a wide array of financial services performed both domestically and internationally for both audit clients and others—has existed for many years.

Each of the large public accounting firms provide accounting and auditing services, tax services, and management consulting services, and the largest firms provide those services globally through overseas offices and foreign affiliates. These characteristics have existed for decades. As the Cohen Commission noted in 1978:

> Before independent audits became widespread in the United States, public accountants were already performing a variety of other services. Public accountants in the early 1900's offered advice on accounting systems, kept accounting records, prepared financial statements and tax returns, and performed a variety of consulting services, including appraisals.

The Cohen Commission also noted that "large corporations typically operate at a number of different locations. A public accounting firm must provide services at many places throughout the country and the world." The Panel on Audit Effectiveness, citing SEC data, noted in its 2000 report that:

> The number of foreign companies that have registered securities in the United States has almost tripled since 1990. . . . The securities of many U.S. companies registered with the SEC are traded outside of the United States, and the financial statements of those companies may be filed with non-U.S. regulators. The financial statements of many U.S. companies and foreign companies are available to investors or creditors in numerous countries, irrespective of the jurisdiction that regulates such companies.

While multifaceted practices of the international accounting firms described above have existed for many years, the extent to which nonaudit services are provided to audit clients and the globalization of the profession have changed over the years. Superimposed on the growth of nonaudit services and globalization is the high level of competition among the firms for audit clients in recent years that many believe has changed the culture of auditing practice.

Certain nonaudit services provided to audit clients—particularly the design and implementation of large integrated information systems and internal audit and valuation services—have long raised concerns about both the fact and the appearance of auditor independence, and thus about the quality of audits. The size of the fees from those services in many cases and their relationship to the amount of audit fees from the same client has added to those concerns. Similar concerns about audit quality are a natural result of a firm's international practice in countries that do not have the same level of accounting, auditing, and quality control standards as the United States. Last, some fear that excessive competition for audit clients has driven audit fees down to a level that cannot support a quality audit but that serves primarily to provide the firm with "a foot in the door" for marketing other services.

Some have suggested that an increasing appetite for growth and profits is now driving the "culture" and "tone" of most accounting firms. Accounting firms sometimes seem to view their clients—even their audit clients—as "business partners." There are also those who contend that audits are sometimes used as "loss leaders" to build a relationship with a client for the marketing of the accounting firm's nonaudit services.

One can question whether, together with the natural reluctance to lose the audit fee, a diminished professionalism makes it more difficult for a firm to reject a client's proposed accounting treatment. There seems to be little doubt that the forces described in this section as presenting challenges to audit quality were present in several of the widely publicized recent business and audit failures. And that, in

turn, suggests the need for additional regulation of the profession and a degree of oversight that significantly exceeds what exists at present.

The SEC's 1998 and 2000 Initiatives

In a September 1998 speech at the New York University (NYU) Center for Law and Business, SEC Chairman Arthur Levitt noted that "qualified, committed, independent, and tough-minded audit committees represent the most reliable guardians of the public interest." He announced that the NYSE and the National Association of Securities Dealers had agreed to sponsor a "blue-ribbon" panel to develop recommendations "to empower audit committees and function as the ultimate guardian of investor interests and corporate accountability." The committee's report was issued in February 1999.

The SEC responded with new disclosure rules in December 1999. Among them is the requirement that a report by the audit committee be included in the company's proxy statement, indicating whether the audit committee has, among other things:

- Reviewed and discussed the audited financial statements with management.
- Discussed with the independent auditors the matters required to be discussed by auditing standards (which includes the quality of the accounting principles and underlying estimates reflected in the financial statements).
- Discussed with the auditors their independence.

In addition, the SEC adopted a rule requiring that the independent accountants review a company's interim financial information before the company's quarterly report is filed.

The major stock exchanges also responded to the committee's recommendations by enacting rules covering the independence, qualifications, and composition of audit committees, including a requirement that committee members be financially literate. The exchanges further required that the audit committee adopt a formal written charter approved by the board of directors; the exchanges also specified that the charter should contain minimum audit committee responsibilities.

Also in 1999, the Independence Standards Board (ISB) adopted Independence Standard No. 1, *Independence Discussions with Audit Committees.* The standard requires that, at least annually, an auditor intending to be considered an independent accountant with respect to a specific entity under the Federal Securities Acts shall:

- Disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence.
- Confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Acts.
- Discuss the auditor's independence with the audit committee.

In his 1998 NYU remarks, Chairman Arthur Levitt also proposed that "the Public Oversight Board form a group of all the major constituencies to review the way audits are performed and assess the impact of recent trends on the public interest." In response, the POB formed the Panel on Audit Effectiveness. Its report and recommendations, issued in August 2000, are discussed below.

In November 2000, the SEC adopted amendments to its auditor independence rules. These amendments to the independence requirements placed limits on certain services, particularly the information technology and internal audit services, that accounting firms may provide to their audit clients without impairing their independence. In those two areas in particular, the final independence rule was not as restrictive as the rule originally proposed—it did not completely prohibit auditors from providing them to their audit clients. In early 2002, in apparent response to concerns emanating from the Enron collapse, the five largest accounting firms announced their intent to no longer provide any internal audit or certain information technology services to their audit clients.

The release containing the SEC's revised independence rules noted the risk of compromised independence when a former partner, principal, stockholder, or professional employee of an accounting firm is hired by an audit client of the firm. Accordingly, under the Commission's final rule, as under the then existing requirements, an auditor's independence is impaired when such an individual is employed in an accounting or financial oversight role at an audit client, unless certain conditions are met. Both the SEC and ISB considered the notion of a mandatory "cooling off" period before accounting firm personnel join an audit client. Neither body adopted it because of concerns it would unnecessarily restrict the employment opportunities of former firm professionals.

The Public Oversight Board's Role in the Voluntary Regulatory Structure

As previously noted, the POB is a private sector body—independent of the accounting firms, the AICPA, and the SEC—that was created in 1977 by the AICPA in consultation with the SEC for the purpose of overseeing and reporting on the self-regulatory programs of the SECPS.

In addition to its ongoing monitoring and oversight responsibilities, the POB has undertaken or commissioned special studies and reviews over the years. The reports emanating from them have had a significant effect on regulation of the accounting profession and the quality of audits. The following are examples of these reports:

- *In the Public Interest: Issues Confronting the Accounting Profession,* which contained recommendations designed to enhance the usefulness and reliability of financial statements, strengthen the performance and professionalism of auditors, and improve self-regulation (1993).
- *Strengthening the Professionalism of the Independent Auditor,* which contained recommendations in the areas of auditor independence, involvement of audit committees and boards of directors with independent auditors, litigation reform, and the relationships among the accounting profession, standard setting bodies, and the SEC (1994).
- Report and Recommendations of the Panel on Audit Effectiveness, which is discussed below (2000).

In addition to its ongoing oversight of the peer review and quality control inquiry processes, the POB's principal activities in 2001 and 2002 centered around monitoring the implementation of the recommendations of the Panel on Audit Effectiveness, overseeing the ASB, and preparing for the reviews of the firms' systems, procedures, and internal controls relating to independence, as discussed below. Over the past year, the POB has made significant additions to its full-time and part-time staff to carry out expanded oversight and monitoring responsibilities called for in the new charter.

The POB's charter affirms that it is independent and specifies that the purpose of the POB's oversight activities is, as noted above, "to represent the public interest on all matters that may affect public confidence in the integrity, reliability, and credibility of the audit process." The public interest is represented by the quality, breadth, integrity, and stature of the members of the POB, which the Board believes should serve as a model for the future membership of any successor oversight body. The POB's first Chairman was John J. McCloy, former High Commissioner for Germany who also served his country in many other capacities over a long and distinguished career. He was followed by Arthur Wood, former CEO and Chairman of Sears, Roebuck & Co., and then by another distinguished public servant, A. A. Sommer, a former SEC Commissioner and securities lawyer. Other former board members included Melvin R. Laird, former Member of Congress and Secretary of Defense, who served on the POB for 17 years, and Paul H. O'Neill, who resigned from the board to become Secretary of the Treasury. The current Board consists of Charles A. Bowsher, former Comptroller General of the United States, who was appointed to the Board in 1999 to serve as its Chairman; Norman R. Augustine, former Chairman and CEO of Lockheed Martin; Aulana L. Peters, former SEC Commissioner; and John H. Biggs, Chairman and CEO of TIAA-CREF. Donald J. Kirk, former Chairman of FASB, resigned as Vice Chairman on January 18, 2002.

The Panel on Audit Effectiveness

As previously indicated, in October 1998, at the request of SEC Chairman Arthur Levitt, the POB appointed the Panel on Audit Effectiveness to examine the way independent audits are performed and to assess the effects of recent trends in auditing on the public interest. The Panel issued its report and recommendations on August 31, 2000. Its recommendations were addressed to many constituencies—standard setters, accounting firms, the SECPS, audit committees, the SEC, and others—and covered a wide range of matters, including:

- Conduct of audits, including the auditor's responsibility for the detection of fraud (including earnings management when it constitutes fraud).
- Leadership and practices of audit firms.
- Effects on auditor independence of nonaudit services provided to audit clients.
- Governance of the auditing profession.
- Strengthening the auditing profession internationally.

The Panel's report received widespread endorsement. SEC Chairman Levitt, for example, stated that "[i]mplementation of the specific recommendations made by the [p]anel to improve the audit process through more comprehensive and vigorous audit methodologies and standards will engender greater confidence among inves-

tors that they are receiving high-quality audits." He also commended the members of the Panel "for their proposals to improve the self-regulatory framework of the profession." POB Chairman Bowsher predicted that the report would play an important part in setting a future course for the accounting profession.

No conclusions can yet be drawn about the extent to which the actions taken to date to implement the Panel's recommendations have enhanced audit effectiveness. The Panel's report was published less than 2 years ago, and the process of responding to the Panel's recommendations is incomplete.

EXPERIENCE WITH SELF-REGULATION

The POB experience with self-regulation of the accounting profession has varied throughout the period of its existence. For years, the profession and the AICPA were responsive to the POB and the need to improve audits to enhance investor confidence in financial statements of public corporations.

The environment changed in recent years as accounting firms expanded greatly the scope of their services which, in turn, led to a reexamination of the concept of independence by the SEC. During the late 1990's, the relationship between the accounting profession and the SEC became very strained, with division among the Big 5 on whether to support or oppose the SEC.

During the same period, the relationship between the accounting profession and the POB also became strained over the adoption of a charter for the POB, particularly with respect to the section in the charter dealing with funding. In effect, the proposed POB charter became hostage to the dispute among the accounting profession and the SEC over resolution of proposed revisions to the independence requirements and rules. But, even during this period, several of the Big 5 supported the POB.

The relationship between the accounting profession and the POB was further strained when the POB, at the SEC's request, attempted to conduct reviews of the Big 5 firms' policies, procedures and internal controls related to independence. The SEC and the firms had agreed to these reviews, and requested the POB to conduct such reviews and issue written reports on them. Some of the firms, unfortunately, adopted an approach that resulted in delay and a lack of progress. This did not permit the POB to conduct the reviews.

In the final analysis, the experience with voluntary self-regulation has been mixed in recent years. The AICPA and several of the Big 5 firms, in the view of some, saw the POB's role as one of a "shield" for the profession rather than as an independent overseer.

Mr. Levitt, the former SEC Chairman, also described this problem in testimony before the Senate Banking Committee in February 2002. "More than three decades ago," he said, "Leonard Spacek, a visionary accounting industry leader, stated that the profession could not 'survive as a group, obtaining the confidence of the public . . . unless as a profession we have a workable plan of self-regulation.' Yet, all along the profession has resisted meaningful oversight."

PROBLEMS WITH THE CURRENT SYSTEM OF SELF-REGULATION

The current system of self-regulation of the accounting profession has significant problems.

First, the funding of the POB is subject to control by the firms through the SECPS, which in the past has cut off that funding in an effort to restrict the POB's activities.

Second, the disciplinary system is not timely or effective. Disciplinary proceedings are deferred while litigation or regulatory proceedings are in process. This results in years of delay and sanctions have not been meaningful. The Professional Ethics Division of the AICPA, which handles disciplinary matters against individuals, does not have adequate public representation on its Board. Investigations by the Quality Control Inquiry Committee of the SECPS, which handles allegations of improprieties in litigation against member firms arising out of audits of SEC clients, do not normally include access to firm personnel and work papers. The disciplinary system does not include the power to issue subpoenas or compel testimony. Thus, investigators must rely on the cooperation of the individual being investigated. The QCIC has no access to the complaining party or the client involved. Furthermore, there is no privilege or confidentiality protection for investigations or disciplinary proceedings, and disciplinary actions are often not made public.

Another problem is that monitoring of firms' accounting and auditing practices by the peer review process has come to be viewed as ineffective, as either a diagnostic or remedial tool. More important, the process has lost credibility because it is per-

ceived as being "clubby" and not sufficiently rigorous. Finally, the peer review team does not examine the work of an audit that is under investigation or in litigation.

Other problems include the fact that the current governance structure does not have the weight of a Congressional mandate behind it. There is also a perceived lack of candid and timely public reporting of why and how highly publicized audit failures and fraud occurred and what actions have or will be taken to ensure that such problems do not recur.

Auditing Standards and Termination of the ISB

The Auditing Standards Board (ASB) was not subject to oversight by an independent entity until it was put under the oversight of the POB in February 2001. In contrast, under the SEC's proposed governance structure for the accounting profession announced in January by the SEC Chairman Harvey Pitt, there will be no oversight of the ASB other than by the profession's trade association, the AICPA. Most of the members of the ASB are associated with the eight largest public accounting firms.

The auditing standards promulgated by the ASB have not provided sufficiently specific and definitive guidance, a weakness noted in the Panel on Audit Effectiveness Report and Recommendations issued on August 31, 2000.

During a speech in January 1978, then-SEC Chairman Harold Williams stated, "The issue of independence is the key one" for the accounting profession. The Independence Standards Board (ISB), which was established in 1997, was terminated in July 2001 because both the AICPA and SEC, for different reasons, did not agree with what the ISB had done. The ISB was established to create, codify, and interpret independence standards for auditors of public companies. Its termination has left a significant void.

The Public Oversight Board Charter

For more than two decades, the POB operated under a set of bylaws, but without the benefit of a charter. Creation of a charter to provide expanded and greater assurances of POB independence became a priority of the Board in December 1999, and was one of the key recommendations of the Panel on Audit Effectiveness, which issued its draft report in May of 2000 and its final report in August of the same year. Yet it took over a year—from December 1999 to February 2001—to negotiate a new charter.

The primary reason for this delay was the resistance of the AICPA and the large firms to various points. For example, the AICPA and accounting profession, contrary to the recommendation of the Panel on Audit Effectiveness, wanted limitations on POB funding. In addition, for many months they opposed giving the POB authority to approve nominations for the chairs of the SECPS executive committee and the ASB, even though they acknowledged that in the past, the POB, in effect, had approved those nominations informally.

In the end, the POB adopted a pragmatic attitude in order to further the public interest. A charter was approved which gave the POB expanded oversight and an enlarged budget and staff. It took effect in February 2001.

The recommendations of the Panel on Audit Effectiveness, including a formal charter for the POB, were designed to improve the existing voluntary self-regulatory system, not to create a new regulatory structure for the profession. At the time of the Panel's recommendations in August 2000, neither the POB nor members of the Panel thought it was likely that Congress would approve a statutory regulatory organization to govern the profession.

Independence Reviews

In a letter to the POB dated December 9, 1999, then SEC Chief Accountant Lynn Turner expressed concern that public accounting firms possibly lacked adequate quality controls for independence. As a step to "safeguard the public interest," he "strongly recommend[ed]" that the POB undertake "a special review of SECPS member firms' current compliance" with independence requirements. On December 21, 1999, the POB agreed to do so. Two weeks later, on January 6, 2000, the SEC announced that an internal investigation at PricewaterhouseCoopers LLP (PwC) had disclosed more than 8,000 independence violations there. At this time, there were publicly expressed concerns that the widespread independence violations at PwC might also be found at other large accounting firms if they were subject to a similar compliance review. Against this background, the POB commenced preliminary work on the special reviews in January 2000, and had meetings with the firms to discuss the reviews.

Then, in early May 2000, the POB's work on the special reviews was stopped by a decision of the SECPS to cut off funding for them. Mr. Levitt, the Chairman of the SEC, stated that this was "a significant setback to self-regulation and inde-

pendent oversight" and raised "serious questions as to the profession's commitment to self-regulation." Melvin Laird, former Congressman and Secretary of Defense and the longest-serving member of the POB, said that this was "the worst incident in my 17 years" on the POB.

The special reviews did not go forward, but shortly afterward, in June 2000, the SEC and the Big 5 firms entered into a "Term Sheet for Independence Look-Back Testing Program" (term sheet), which called for the POB to conduct more limited independence reviews.

Subsequently, on October 10, 2000, the POB received a letter from Mr. Turner asking that the POB do the independence reviews called for by the term sheet "in lieu of" the special reviews previously requested in his December 1999 letter to the POB. The POB agreed to do so, and commenced preliminary work on these reviews in November 2000. Between then and January 2002, a period of more than a year, the POB did a substantial amount of work preparing to conduct the independence reviews. This work included a request for documents sent to the firms and the SEC staff in July 2001, as well as comprehensive work programs for both phase I (evaluation of design and implementation effectiveness) and phase II (testing and evaluation of operating effectiveness) of the reviews, sent to the firms and SEC staff in October 2001 and January 2002, respectively. In addition, the POB was involved in working with the firms on a confidentiality agreement for the independence reviews. The POB's efforts to enter into a confidentiality agreement with the firms, going back to July 2001, met with no success. In addition, by the middle of January 2002, the POB still had not been able to obtain from the firms documents it had requested for the independence reviews in July 2001. This lack of progress in conducting the independence reviews was one of the factors that led to the POB voting to terminate its existence.

In a letter to the SEC and the firms dated March 5, 2002, the POB set forth its position on the transfer of its responsibility for conducting the independence reviews to an independent person and discussed the background of the independence reviews. This letter can be found on the POB's website at *www.publicoversightboard.org.*

The Public Oversight Board Decision to Terminate

As noted above, although the POB commenced preliminary work on the independence reviews in November 2000, by January 2002, it still had not been able to obtain information and documents it had requested from the firms in July 2001. The POB was concerned that the lack of progress on the independence reviews would continue. This lack of progress was one of the considerations that caused the POB to vote its intention to terminate its existence no later than March 31, 2002.

However, the precipitating factor in the POB's decision to terminate was the announcement of a proposed new self-regulatory structure by SEC Chairman Pitt. The POB was not consulted on this new proposed governance structure for the accounting profession, announced by Mr. Pitt at a press conference on January 17, 2002, even though the POB had requested and been assured that it would have the opportunity to provide input as the proposals were being developed and prior to any public announcement. Instead, without including the POB in the process, the SEC worked privately with representatives of the AICPA and the Big 5 firms and developed the new SEC proposal. Thus, the private sector entity which was charged with oversight of the profession's self-regulatory activities and with representing the public interest had no input into what may well be the most significant change in regulating the accounting profession in the last 30 years.

A January 23, 2002 article in *The Wall Street Journal* reported that a spokesman for PwC confirmed that chief executives of the Big 5 firms, including PwC, had held a series of private meetings with the SEC Chairman in Washington between December 4, 2001, and January 17, 2002, on this matter, and that the gatherings "took place at Mr. Pitt's invitation."

On the same day that one of these meetings was being held, December 4, 2001, Charles Bowsher, Chairman of the POB, had a discussion with Barry Melancon, President and CEO of the AICPA, at the John J. McCloy dinner hosted by the POB. During this discussion, which also included James Castellano, Chairman of the AICPA, Mr. Melancon told Mr. Bowsher that the profession and the SEC were working on proposed changes to the governance structure of the accounting profession. Mr. Bowsher specifically asked that the POB be included in any such discussions so that it would be able to provide input before any public announcement of a proposed new structure. Mr. Melancon assured Mr. Bowsher that this would be done.

At a meeting of the SECPS executive committee on January 4, 2002, Mr. Charles Bowsher, Aulana Peters, a POB member, and Jerry Sullivan, the POB Executive Director, were told that a proposed governance structure for the profession would be

announced within a month. Messrs. Bowsher and Sullivan and Ms. Peters asked that the POB be "brought in the loop" and be given an opportunity to participate. They were told the POB would be consulted.

The SEC did not seek input from the POB on the new regulatory structure. While Chairman Pitt had left a voice message for Mr. Bowsher on January 10, 2002, and Mr. Bowsher had called back twice, in the end Mr. Bowsher did not receive a return call and the two men did not speak before the press conference.

On January 17, 2002, Mr. Bowsher received a call from Mr. Melancon and Robert Kueppers, Chairman of the SECPS executive committee, a few hours before Mr. Pitt announced the new SEC proposal at a press conference. In this call, Mr. Bowsher asked specifically if there would be a place for the POB in the new structure. Mr. Melancon replied that there was no place for the POB in the new regulatory structure to be announced by Mr. Pitt and that the POB would be a redundancy. Subsequently, the POB was advised by the Chairman of the SECPS that the SECPS working group had provided the SEC with an outline of a proposal a week before the January 17, 2002 press conference.

The POB believes that one of its primary functions is to facilitate communication. The Panel on Audit Effectiveness found that "The POB should serve as the oversight body to whom the SEC, the State boards of accountancy, the auditing profession and the public should look for leadership. This leadership position is intended to enhance communications among the profession's self-regulatory bodies in order to facilitate the profession's continuous improvement efforts and identify and resolve important issues on a timely basis." The Panel recommended that the SEC should "[s]upport the POB's authority as enumerated in its charter to enable the POB to serve as an independent, effective, unifying leader of the profession's voluntary self-regulatory process."

During Chairman Pitt's press conference on January 17, he was specifically asked whether there would be a role for the POB in the new SEC proposal. He did not answer the question.

John Coffee, the distinguished Columbia Law School Professor who has written extensively about securities regulation, faulted the SEC chair for the way in which the new regulatory structure was created. Professor Coffee said that "It is not the high watermark of public accountability when the industry to be regulated designs its own regulatory structure in negotiations with its former lawyer."

The foregoing was the context in which the POB voted unanimously on January 20, 2002, its intention to terminate its existence pursuant to Section IX of the POB's charter no later than March 31, 2002. The reason for this action was that the new SEC proposal had been worked out by the SEC, in collaboration with the AICPA, SECPS executive committee and representatives of the Big 5 firms, without any consultation with the POB, which is charged with representing the public interest. The new proposal rendered the POB a "lame duck." In making its decision, the POB was also cognizant of the experience of negotiating its new charter, the fact that the SECPS had cut off funds for the special reviews, and that there had not been progress in connection with the reviews to which they had agreed. The POB believed it could not effectively oversee the activities of the accounting profession under the circumstances and that it would mislead the public to appear to do so. Furthermore, if the POB were to continue during an interim period before a new governance structure were in place, it believed it would leave the impression that it approved of the Pitt proposal. As the "conscience and critic" of the profession, the POB felt it had no choice but to terminate its existence to protect the public interest. What the POB did was akin to what an auditor does when it believes it must resign from a client engagement because of a fundamental disagreement.

THE PUBLIC OVERSIGHT BOARD PROPOSAL FOR REFORM

The Public Oversight Board is mindful that there are many suitable models that could be adopted as part of a reform program for regulation of the accounting profession. Congress will undoubtedly consider many of the available options in coming weeks as decisions are made on regulatory changes in the aftermath of the Enron debacle. Whatever the details of reform, the POB strongly believes that a legislative foundation for any future regulatory structure is crucial.

Because it has had oversight responsibility for a good portion of the voluntary self-regulatory structure of the accounting profession for the past 25 years, the POB has first-hand knowledge of the strengths and weaknesses of the existing system and, thus, a unique perspective on regulatory reform. The POB considered a number of options for reform based on the present system, but ultimately came to the conclusion that a complete overhaul is essential. The Board believes that the existing system has become ineffective.

Dating back to the 1970's, when bribery of foreign officials by American corporations was first uncovered, followed by the audit failures associated with the bankruptcy of the Penn Central railroad—the Enron failure of its day—reforms have been largely incremental and piecemeal. The creation of the POB and other early reforms grew out of hearings in the House and Senate that followed the Penn Central bankruptcy and the "sensitive payments" scandal. While the POB believes that many of these early reforms served a useful purpose and strengthened the profession, it is also clear that in recent years, regulatory oversight and attempts at further reforms have been met with resistance or outright rejection by the profession. As noted earlier in this paper, the profession over the past 2 years has acted to preserve the status quo and has resisted major reform efforts.

Faced with this opposition, the Public Oversight Board believes the time for legislative action has come. The current system needs to be replaced. To accomplish this, the POB believes it is essential that all critical elements of regulation—including all standard setting, inspections and reviews of accounting firms, enforcement and discipline, and other functions—be placed under the aegis of a single regulator operating under statutory authority. This new entity—an Independent Institute of Accountancy (IIA)—would employ a professional staff of individuals unaffiliated with the profession or any of the Big 5 accounting firms and would be run by a seven-member Board, which itself would be totally independent of the profession.

The SEC would have oversight of the IIA, and the SEC's Office of the Chief Accountant would be the liaison to the IIA. A chart showing the organizational structure of the IIA is attached as Appendix A.

The Board

Under the POB's model, the chair and vice chair of the IIA Board would be employed on a full-time basis. Five other members would serve on a part-time basis. Each member, including the chair and vice chair, would serve a 5 year term and no member could serve more than two consecutive terms. To assure future continuity, it is anticipated that the initial membership of the Board would have staggered terms. While qualified persons with accounting experience, such as retired accounting professionals, would be allowed to serve on the Board, the majority of members would have no ties whatever to the profession.

The importance of independence cannot be stressed enough. Independence removes any conflict of interest—real and apparent—on the part of Board members. Independence enhances the likelihood that when the narrow needs of the profession conflict with the broader public interest, it is the public interest that will be served. Independence will also serve the interests of the accounting profession itself. Because the accounting profession depends on the trust of investors and the public, that trust will wither and die if the profession is seen to be self-serving in its actions. The best way to keep that trust is to place regulatory decisions at arms-length in an independent, legislatively mandated oversight structure within the private sector.

The chair of the Board would be selected by a committee composed of the chair of the SEC, the chair of the Federal Reserve Board and the Secretary of the Treasury. Once named, the IIA chair would become a member of the selection committee and would join in selecting the vice chairman and the other members. To assure independence, members could be removed only by a two-thirds vote of the IIA Board itself. Having a selection committee of these individuals would enhance the credibility of the Institute.

Standards and Interpretation

The POB charter gave it authority to oversee the issuance and interpretation of auditing and independence standards for the profession by the ASB and the ISB. Accounting standards have been set for nearly three decades by FASB.

The POB believes it is time to consolidate all standard setting bodies under one roof. Thus, a basic and critical function of the new Institute would be oversight of the issuance and interpretation of accounting, auditing and independence standards for the profession. To accomplish this end, an Office of Standards would be created by the IIA Board and would report to it. Within the Office of Standards, separate bodies would be created to issue accounting standards, auditing standards, and independence standards. While the POB envisions a system in which the IIA Board would have overall authority to create the structure under which standard setting would take place and to make appropriate rules for the standard setting process, the standard setting bodies within the Office of Standards would be given considerable autonomy in carrying out their work. A well-staffed and funded research arm within the Office of Standards would support the standard setting entities. The Of-

fice of Standards would also be charged with issuing interpretations of standards and be subject to monitoring by the IIA Board.

With respect to FASB, the POB is cognizant of its hard work in setting accounting standards for nearly three decades, but believes it should be integrated along with all standard setting bodies into one unified and coordinated structure under the aegis of the IIA. Placing the responsibilities of FASB under the new IIA would lessen the chances of it being influenced by those whose its standards affect and could likely help alleviate what some—including the current SEC Chairman—have said is a slow process for promulgating standards. As Lee Seidler, Deputy Chairman of the 1978 AICPA Commission on Auditor's Responsibilities, testified before the Senate Banking Committee in March 2002, "FASB has been beset by enormous outside pressures." Also, former SEC Chairman David Ruder expressed similar concerns before the same committee in February 2002, noting that "FASB continually faces difficulties in financing its operations."

These problems would be alleviated because FASB's independent funding would be guaranteed by the IIA. Further, one of the major advantages to placing the activities of FASB under the new IIA would, as Mr. Turner testified before that committee in February 2002, be "the accounting standard setting, and enforcement of those standards, residing within a single organization. In turn, when the disciplinary process identifies shortcomings in the standards, they could then be promptly referred to the standard setter for timely action."

With respect to auditing standards, the POB believes that standards promulgated by the current ASB have not provided guidance that is sufficiently specific and definitive, a problem noted in the recommendations of the Panel on Audit Effectiveness. The ASB is controlled by the AICPA, and eight of its 15 members are partners of the eight largest accounting firms. As with other standard setting entities, it should be placed under the aegis of the newly created Institute.

As was discussed earlier, the termination of the ISB—established to create, codify, and interpret independence standards for auditors of public corporations—has left a significant void. The POB believes this void should be filled by creating a new entity independent of the profession and operating under the aegis of the Institute, with sufficient resources and staff to issue clear, unambiguous standards of independence.

As to the membership of the separate bodies that would be created under the Office of Standards of the IIA, the POB believes a majority of their members should be independent of the profession. The new Office of Standards with separate bodies would help alleviate the concerns expressed by former SEC Chief Accountant Michael Sutton, who testified in February 2002 before the Senate Banking Committee that "standard setters too often pull their punches, backing down from solutions they believe are best—perhaps because of a perceived threat to the viability of private sector standards setting—perhaps because of the sometimes withering strains of managing controversial, but needed change—perhaps because of a loss of focus on mission and concepts that are supposed to guide their actions." Public representation would assure that, at the least, the public had a voice and a vote in the process.

Annual and Special Reviews

Since 1977, peer review of one accounting firm by another has been the backbone of the voluntary self-regulatory system in the United States, and the POB has been charged with overseeing this process. The POB believes that peer review resulted in major improvements in the profession. The recommendations that flowed from peer reviews in the early days led to substantive improvements in the quality controls at accounting firms, large and small. At the same time, as former SEC Chairman Williams testified on February 12, 2002, before the Senate Banking Committee, peer review "in its present form [has become] too incestuous. A system needs to be established which is independent of the accounting profession."

Because it is not a transparent system (details of peer reviews are not made public) and is limited in scope (audits subject to investigation or litigation are not looked at as part of a peer review), peer review has come under considerable criticism from Members of Congress, the media, and others. "You scratch my back, I will scratch yours" is the prevailing cynical opinion of peer review raised by many.

The Public Oversight Board is of the opinion that peer review, as it has been conducted, should be discontinued in favor of a more thorough, independent, and transparent system. Each accounting firm now carries out an internal inspection each year. The POB would mandate that, for firms that audit more than 100 public corporations each year, these inspections would be subject to a comprehensive and thorough review, carried out by an independent professional staff hired by the Institute. While these reviews would usually look at a representative sample of a firm's

work, IIA reviewers would have the authority, unlike current peer reviewers, to look at any aspect of a firm's operations it might find appropriate. Details would be compiled in reports that would be made available to the public. Reviews of smaller audit firms would be performed by other firms selected and paid by the IIA. Their reports would be addressed to the IIA as the client of the reviewer.

Professor Joel Seligman, who testified before the Senate Banking Committee in March 2002 stated that "the most significant issue may prove to be who conducts periodic examinations and inspections. To paraphrase the classical adage: Who will audit the auditors? I would urge serious consideration be devoted to replacing peer review with a professional examination staff in the new SRO. Peer review has been, to some degree, unfairly maligned. But even at its best it involves competitors reviewing competitors. The temptation to go easy on the firm you review lest it be too critical of you is an unavoidable one."

But these reviews are only one piece of an updated oversight structure. To supplement them, the POB believes that special reviews should be carried out, when warranted, on a case-by-case basis. These special reviews, similar to those the SEC originally asked the POB to undertake of the Big 5 firms, could take a more systemic and in-depth look at a firm's systems, policies, procedures and operations. If necessary, they would delve deeply into questions affecting a firm's compliance with SEC rules and applicable professional standards. As with annual reviews, an independent professional staff hired by the Institute would carry out any special reviews and results would be public.

Enforcement and Discipline

One of the most pervasive complaints about the current voluntary system is that firms and their personnel are rarely disciplined by the profession for infractions in carrying out audits or other work.

Dave Cotton, a member of the AICPA's Professional Ethics Committee's Technical Standards Subcommittee, wrote in a January 2002 *Washington Post* article that, while the Ethics Committee expels someone from the AICPA 5 to 10 times a year, "[m]ore typically, when [that] committee finds that a CPA has violated professional standards, it orders continuing professional education classes. A CPA found to have violated an accounting standard in connection with a multibillion-dollar corporate collapse, causing massive damage to investors and the public, might receive this minimal sanction."

When discipline is imposed by the present system, it almost always comes years after the fact because of procedures which delay the process, including sanctions, until after the outcome of litigation. Mr. Cotton noted in *The Washington Post* article cited above that, as a result of delays in the disciplinary system, "accountants who have committed the most egregious ethical lapses—the ones resulting in SEC investigations, bankruptcy and litigation—can often continue to practice for 10 years or more after the alleged violation until all the cases are resolved." Bevis Longstreth, a former SEC Commissioner and member of the POB's Panel on Audit Effectiveness, stated in his Congressional testimony in February 2002 that the present system "results in long delays in investigation and, as a practical matter, renders the disciplinary function a nullity in almost all instances."

The POB believes that these concerns about the present system have validity and that an effective mechanism for timely and effective discipline is essential to any reform effort.

One reason for the delay in the current system stems from the fact that those charged with administering the system lack privilege to ascertain facts. Privilege would give the investigative entity the authority to protect information it uncovers from outside demands until any enforcement action is concluded. At present, firms will not disclose documents or other information that is likely to wind up in the hands of litigants in legal proceedings. As Shaun O'Malley, Chairman of the POB's Panel on Audit Effectiveness and former Chairman of Price Waterhouse, pointed out in his testimony in March 2002 before the Senate Banking Committee, the present system has been "hampered by distrust and by concerns that the materials developed were not protected. Providing confidentiality will expedite and vastly improve the review, investigatory, and disciplinary processes."

Further hampering those charged with discipline in today's system is the lack of subpoena power. Because of this, the system may not be able to obtain important information from auditors or audit clients. Also, sanctions are limited; the most that can be done is expel someone from membership in the AICPA. Further, the disciplinary process is not transparent, so the public is often unable to determine what, if any, action has been taken, even with respect to major audit failures.

The POB suggests that an Office of Enforcement and Discipline be formed within the new IIA to have full legal authority to investigate allegations of wrongdoing by

public accounting firms and their personnel, including subpoena power. The Office would be staffed by accounting and other professionals, as well as investigators. Cases of alleged improper professional conduct would be brought before IIA hearing officers, who would be charged with recommending, where warranted—after public notice and opportunity for public hearing—that the IIA Board impose sanctions that would range from fines to suspension or expulsion from the profession. Cases could be referred to the Justice Department for possible prosecution, or to the SEC, State boards of accountancy, or other agencies, as appropriate.

The allegations brought before the Office of Enforcement and Discipline would go forward to investigation regardless of any pending litigation, unlike the present system. Disciplinary hearings and decisions would be public.

Funding and Staff

If the Institute is to be successful in all that it is charged with overseeing and regulating, it must be appropriately funded and it must have an adequate, well-trained staff. It is clear that to attract a talented staff, competitive salaries must be available. Further, the Institute must be assured that the funds will be there when needed.

Former SEC Chairman Williams testified before the Senate Banking Committee in February 2002 that the POB "is not adequately funded and is beholden for its funding to the very people it is supposed to oversee. I suggest that the SEC consider a requirement that a percentage of the audit fees of public companies be assessed to pay for independent oversight, whether it is the Public Oversight Board or a successor body, so that its funding is assured."

Another former Chairman of the SEC, David Ruder, said in testimony the same day that: "Independent and adequate funding is crucial. An independent body that depends upon sporadic voluntary contributions from industry or the financial community may risk loss of financial support if it takes positions seen as contrary to the best interest of those it regulates."

The POB recommends that funding be provided through fees imposed on public corporations in an amount that would be sufficient to cover the costs of the Institute. The fees would vary according to the total revenues of the corporation. The POB strongly believes that the funding mechanism must be beyond the reach of the profession to prevent it from withholding necessary funds, as it did in May 2000.

International Liaison

Convergence of international accounting and auditing standards is one of the most pressing issues facing the profession. In an era when major firms either own or are affiliated with large accounting entities throughout the world and major corporations engage in global trade, common accounting and auditing standards are fast becoming a critical need. The Public Oversight Board believes that international liaison should be a primary function of the Institute.

Paul Volcker, the former Federal Reserve Chairman and Chairman of the Trustees of the International Accounting Standards Board (IASB), told the Senate Banking Committee in February 2002 that FASB and IASB were working together on a number of issues and that the "result should be convergence and significant improvement in both bodies of standards." Since the IIA would oversee accounting standard setting as well as auditing and independence standard setting, the Institute would be in the best position to act as international liaison to promote convergence and significant improvement to United States and international standards. This is a POB function under its charter and should be transitioned to a new regulatory body.

Continuing Professional Education

Education has always been a hallmark of the accounting profession, and accountants and auditors are required to accumulate 80 hours of continuing professional education credits every 2 years. As important as education has been in the past, however, it will become even more crucial in years to come. The ability of auditors to deal with audits of companies involved in cross border offerings and derivatives and other new financial instruments that are constantly being invented is largely dependent upon their ability to understand them—and that is a function of education. Similarly, convergence of standards across international boundaries will present new and unprecedented challenges to accountants and auditors and only continuing education will make it possible for the profession to remain on top of new developments. For these reasons, continuing education should be a primary focus of the new Institute.

Other Matters Affecting the Profession

Beyond the regulatory structure of a new system, the POB believes there are a number of other issues that should be addressed as part of legislation creating a charter for the new Institute.

Auditor Independence

The POB recognizes that there are several models available to deal with the matter of auditor independence and that there continue to be disagreements on this matter.

The Panel on Audit Effectiveness, for example, was split on the issue of scope of services for audit clients. Some Panel members wanted to essentially ban nonaudit services for audit clients. But these members would have allowed a "carefully circumscribed exception" if the client's audit committee (composed only of independent directors) found that the best interests of the company and its shareholders would be served by retaining its auditor to render such nonaudit services in cases where "no other vendor of such service can serve those interests as well." This proposal would also have required submission of such a finding to the SEC and POB and disclosure in the corporation's proxy statement of the finding and the amount paid for the nonaudit services.

On the other hand, those on the Panel who opposed restricting nonaudit services—a majority—held that "audit firms can provide both audit and nonaudit services to the same public audit client, and with proper safeguards and disclosures, can maintain independence and objectivity." Those taking this view believed that "nothing in the long history of the profession's providing nonaudit services has indicated otherwise."

Mr. Volcker said during the September 2000 public hearings on the SEC's proposed independence rules that:

> The extent to which the conflict has in practice actually distorted auditing practice is contested. And surely, instances of overt and flagrant violations of auditing standards in return for contractual favors—an auditing capital offense so to speak—must be rare. But more insidious, hard-to-pin down, not clearly articulated or even consciously realized, influences on audit practices are another matter.

Importantly, President Bush's 10-point plan "to improve corporate responsibility and protect America's shareholders," announced in March 2002, provides that "Investors should have complete confidence in the independence and integrity of companies' auditors." The specifics on this plan recognize the importance of prohibiting certain nonaudit services in order to safeguard auditor independence.

On February 1, 2002, the AICPA issued a statement, which said it "will not oppose Federal legislation restricting the scope of services that accountants may provide their public audit clients, specifically in information technology and internal audit design and implementation."

In considering this matter, the POB started from the premise that the accountant's audit and report add significant credibility and reliability to a corporation's financial statements in the process of capital formation and that the foundation of that credibility is auditor independence.

To effectively assure independence, the POB believes legislation governing nonaudit services to audit clients is necessary. The POB proposes that SEC regulations concerning independence be legislatively codified with appropriate revisions to update restrictions on scope of services involving information technology and internal audit services as noted above.

The POB believes such legislation should also affirm that tax work not involving advocacy and attest work in connection with SEC registration and other SEC filings be allowed, and that small public businesses, to be defined by the SEC, should not be subject to any restriction on nonaudit services. Further, with respect to nonpublic corporations, it is the POB's position that such corporations and the accounting firms that audit them should not be subject to any restriction on nonaudit services. We expressly emphasize this to avoid misunderstanding and any consequences to small business and small audit firms.

The IIA Office of Standards should be empowered to promulgate appropriate rules affecting independence to cover changing circumstances. The POB also believes that nonrestricted, nonaudit services should require approval by the audit committee if it finds such services to be compatible with maintaining independence. Also required would be prompt notification to the IIA Office of Standards and public disclosure in current reports and proxy statements filed with the SEC.

The POB believes there should be no prohibition against an audit firm offering nonaudit services to nonaudit clients.

Auditor Rotation and Retention

The POB believes that the time has come to require the rotation of auditors every 7 years. The one effective way to prevent the emergence of too close a relationship between a corporation and its auditor is to make certain that auditors are rotated periodically. While there is merit to the argument that a long-term relationship helps the auditor do a better job, it is also true that a new auditor every 7 years would provide the corporation with the benefit of a fresh perspective.

The POB agrees with its member, John Biggs, who testified in February 2002 before the Senate Banking Committee that auditor rotation is a "powerful antidote" to auditor conflicts of interest, which "reduces dramatically the financial incentives for the audit firms to placate management." In addition, as Mr. Biggs stated, "rotation reduces the problem of cross-selling other services and is likely to eliminate the revolving door that allows former auditors to become the top financial officers of the audited company." The POB also supports Mr. Biggs' idea, described in his testimony, that the new auditor at the time of rotation should do "an exhaustive review of the former audit work papers" that would assure "transactions and documentation were fully transparent." In addition, the new auditor could do "a brief, signed peer review report" on its predecessor.

As a corollary to auditor rotation, the POB recommends that public corporations be prohibited from firing auditors during their term of service. As former SEC Chairman Williams stated in his testimony before the Senate Banking Committee, the benefit of such a retention requirement is that "the auditor would be assured of the assignment and, therefore, would not be threatened with the loss of the client and could exercise truly independent judgment."

The POB recommends allowing an exception to this retention requirement if the audit committee determines that an exception is in the best interest of shareholders, with prompt notice to the IIA and the SEC. Such action would be required to be publicly disclosed by corporations in current reports and proxy statements filed with the SEC. The POB also believes that audit committees, in engaging the auditor, should give primary consideration to the quality of the audit firm and its audit plan, and not to the lowest price.

The POB is cognizant that if an auditor rotation regulation is included in legislation, action will have to be taken to phase in the new system. The POB recommends giving the IIA authority to promulgate new rules governing the transition to an auditor rotation system. Actual rotation of auditors would begin only after those rules are in place.

Cooling Off Period

For many years, Members of Congress and senior Federal Government officials have been required to enter a "cooling off" period during which they are prohibited from taking certain actions, such as lobbying, on behalf of their new employer. The objective is obvious: To guard against undue influence by former colleagues and friends when it comes to making Government decisions that could benefit the new employer of the former official.

The POB believes such a cooling off period is sound policy and feels a variant of it should be applied to the accounting profession when senior partners leave their firms. Specifically, the POB recommends that engagement and other partners who are associated with an audit be prohibited from taking employment with the affected firm until a 2 year period has expired. This would end the current situation in which there is at least the appearance of impropriety in audit firms being unduly influenced by former colleagues who have taken senior positions with existing audit clients.

As Mr. Seidler said in his testimony this February, "the former auditor knows exactly how his or her former firm conducts the audit," and also "knows how far former compatriots can be pushed to accept results preferred by management." Mr. Seidler added that "'we are all friends,' is not exactly the appropriate relationship between independent auditor and client."

It is also important to recognize that in the cases of Lincoln Savings and Loan, Waste Management and, most recently, Enron and Global Crossing, senior financial officers at the company came from the outside audit firm.

Under the POB proposal, the IIA Board would have the authority to adopt specific rules affecting this proposed cooling off period.

Audit Committees

The POB believes that the Institute should expand on the recommendations of the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees,* which made it clear that the external auditor should be accountable to a firm's board of directors and its audit committee and

not to management. Specifically, the POB believes audit committees should take full responsibility for hiring, evaluating, and—if necessary—terminating an audit firm.

Conflicts of Interest

To discourage conflicts of interest involving public corporations, Congress should amend the Securities Exchange Act of 1934 to require more meaningful and timely disclosure of related party transactions among officers, directors, or other affiliated persons and the public corporation. Such disclosures should be made promptly in current reports as well as in proxy statements filed with the SEC.

Internal Controls

In the 1980's, a series of major business failures, particularly those involving financial institutions, led to Congressional hearings on auditing and financial reporting matters. Out of those hearings, the FDICIA became law. This Act required among other things, that management report on internal controls and, further, that the independent auditors examine and report on those management assertions.

The Special Report by the POB dated March 5, 1993 on "Issues Confronting the Accounting Profession" recommended that the SEC require public companies to include with their annual financial statements "(a) a report by management on the effectiveness of the entity's internal control system relating to financial reporting; and (b) a report by the [entity's] independent accountant on the entity's internal control system relating to financial reporting." The POB, in support of this recommendation, stated: "The Board believes that requiring auditors to assess management's reports on the quality of internal controls will benefit the public. First, the auditing profession's evaluation of internal control systems will lead to improvements in those systems. Second, as long as companies' boards and top management demand conformity with those systems, the improved systems will make management fraud and manipulation of financial reporting more difficult."

Just a few months later, in a June 1993 position statement, the AICPA Board of Directors stated:

> To provide further assurance to the investing public, we join the POB in calling for a statement by management, to be included in the annual report, on the effectiveness of the company's internal controls over financial reporting, accompanied by an auditor's report on management's assertions. An assessment by the independent auditor will provide greater assurance to investors as to management's statement. The internal control system is the main line of defense against fraudulent financial reporting. The investing public deserves an independent assessment of that line of defense, and management should benefit from the auditor's perspective and insights. We urge the SEC to establish this requirement.

The General Accounting Office discussed this issue of reporting on internal controls in its 1996 report, "The Accounting Profession." The GAO pointed out that the POB had said "it was disappointed by the failure of the SEC to take action to mandate issuer and auditor reporting on internal controls. The POB agreed with us that such action would add immeasurably to the ability to prevent and detect fraud and would in general enhance the quality of finance reporting." The GAO stated that the SEC was "the key player" here and, further, that the SEC should move forward on this important issue. So far, the SEC has not done so.

Management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. The corporation's chief financial officer and chief executive officer should sign this attestation and the auditor should review it. An auditor's review and report on the effectiveness of internal controls would—as the GAO found in its report—improve "the auditor's ability to provide more relevant and timely assurances on the quality of data beyond that contained in traditional financial statements and disclosures."

In addition, strengthened internal controls over financial reporting should improve quarterly statements, interim disclosures and earnings estimates that are the basis for many market price changes during the year. They should also be helpful in avoiding restatements that are now seen so frequently.

CONCLUSION

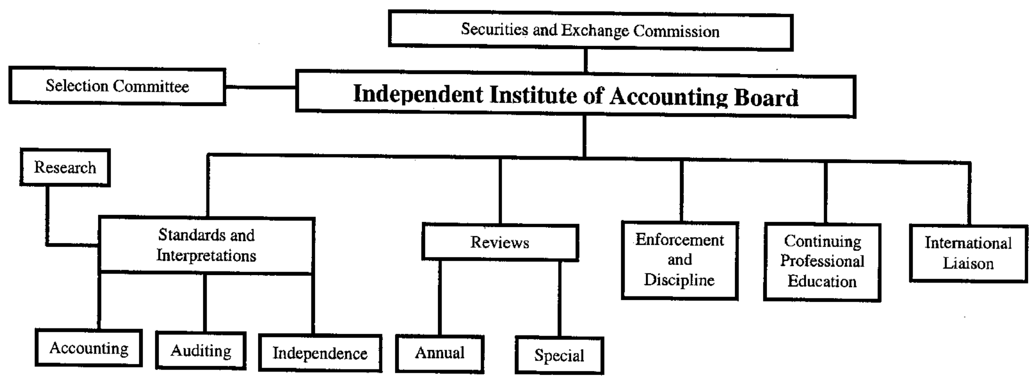
The Public Oversight Board has not come lightly to its recommendations for reform. For many months, members of the POB hoped that patient negotiation and discussion would prevail. In the end, however, it became very apparent to the POB that real reform will take place only when the Congress requires it through legislative action.

A decade ago Congress acted in the public interest when it voted major reforms in the banking industry—reforms that were widely opposed by the banks and their lobbyists. Opponents then predicted gloom and doom for the industry should the proposed reforms be enacted. In reality, the reforms contained in the FDICIA repaired flaws in regulation of the Nation's banking industry. More important, they significantly strengthened the industry.

Today, the Congress again is called upon to institute reform. In the wake of the Enron debacle, the POB, acting as the "conscience and critic" of the profession, strongly believes that to protect investors and the public, the old system of voluntary self-regulation for the accounting industry must be replaced. While many will urge that Congress act with caution and that the profession be again given the opportunity to fix the present system with marginal changes, the POB believes it is time to resist the continuation of the status quo and move ahead with fundamental change.

In short, the POB believes it is time for Congress to enact the kind of reform that will make a real difference.

Appendix A


Securities and Exchange Commission
Selection Committee
Independent Institute of Accounting Board
Research
Standards and Interpretations
Reviews
Enforcement and Discipline
Continuing Professional Education
International Liaison
Accounting
Auditing
Independence
Annual
Special

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

January 22, 2002

Via Facsimile

Charles A. Bowsher,
Chairman
Public Oversight Board
4503 Boxwood Road
Bethesda, MD 20816

Dear Chuck:

I want to respond to your letter of yesterday's date, which I received only this morning, advising me that the Public Oversight Board intends to terminate its existence. I do not believe this is in the public interest, and I strongly urge you to reconsider.

Your letter seems to be premised on the assumption that any new private regulatory structure would not include the POB. That premise is incorrect. The preliminary proposal, which I introduced last Thursday, envisions a Public Accountability Board outside the AICPA. This new Board would have direct involvement, not just oversight, of two important functions: auditor discipline and quality control monitoring.

Nothing I said on Thursday, or since, was in any way intended to suggest that the POB had no role to play. Indeed, my proposals were intended to strengthen the body that will be our "new" POB, insure its independence from the AICPA, and expand its mandate.

I believe my proposal is an important step forward. I would like, and welcome, your help. The issues, I think, are too important for the POB simply to walk away.

Sincerely,

Harvey

Harvey L. Pitt

In response to today's announcement by the Public Oversight Board, Securities and Exchange Commission (SEC) Chairman Harvey L. Pitt said:

"I am very disappointed by the Public Oversight Board (POB)'s announcement today that it will not reconsider its January 20 decision to terminate its existence by March 31, 2002.

"I still believe that the POB could have played an enormously helpful role in ensuring that the independence and effectiveness of the new structure are strengthened and hope that some individuals from the POB will share their insights with us.

"We will continue to work on the process we announced on January 17 to reform the accounting profession's regulatory structure and assure the investing public that the SEC will make sure that there is no gap in oversight of the profession due to the POB's action.

"In the interim, the peer review and quality control inquiry functions of the SEC Practice Section will continue, as will the important oversight activities of the POB staff until transition to the new structure is complete."

January 31, 2002

FEBRUARY 5, 2001
FORTUNE

The Price of Being RIGHT

Star analyst Mike Mayo thought he could change the ratings game on Wall Street. He thought he could be honest—and tell people to sell stocks that were headed for a meltdown. It cost him his job.

by David Rynecki

THE SALESMEN WERE EAGER. AS MIKE MAYO BEGAN TO address the early-morning meeting at Credit Suisse First Boston on May 24, 1999, the crowd seemed unusually perky, pulling to the edge of their seats. Maybe that was because of the recent explosion on Wall Street. After smashing through the unthinkable 10,000 barrier just two months before, the benchmark Dow industrials had everyone from mom-and-pop investors to the big institutions juiced to buy.

Or maybe the reason was the man speaking. At the podium was one of CSFB's most celebrated researchers—the No. 1 regional banking analyst in the influential *Institutional Investor* rankings, someone whose stock picks had averaged a 52% annual gain over the previous four years, and one of the biggest bulls in the sector. There was no question the 36-year-old was respected by peers for his thoughtful analysis. But what had given this energetic, self-assured analyst his most dedicated following was "the call." Back in December 1994, when bank stocks were drearily trudging through a bear market, Mayo saw the bottom near and pointed investors up. Saying the sector had turned a corner and would be propelled by cost savings and merger mania, he shouted "Buy!" across the board. His gutsy move left more established analysts scratching their heads. But the call, it turns out, was as good as money in the bank. Within a month the group's stocks had reversed course. And over the next few years Standard & Poor's bank index would post a total return of 254%.

Now, in the spring of 1999, the time was right for another dose of adrenaline, many salesmen felt, a touch more cheerleading. As for Mayo, all he could feel was the knot in his stomach. Dressed more formally than usual in a freshly pressed dark blue suit, white shirt, and tie, and armed with a thousand-page report analyzing 47 U.S. banks, he leaned forward to speak: "In

Within minutes after the meeting, word had spread across Wall Street. The early reaction was not good. "You don't put a sell on blue chips!" barked one angry portfolio manager.

no uncertain terms," he declared, "sell bank stocks."

The room was silent. The brokers, motionless. Many had never heard anything so bearish come out of the mouth of a colleague, particularly in such a public setting. They were uncertain how to convey this message to their clients at the biggest hedge funds, pension funds, and mutual funds. "Did he really say what I thought he said?" one rep recalls asking another. Mayo himself felt relieved. He left the room after speaking for five minutes, only to be summoned back for more questions. He assured them of his resolve, then again returned to his office and collapsed into a chair.

Nearby, analysts Dave Trone and Brad Ball, who worked as Mayo's research partners, were already placing calls to major clients and fielding questions. Mayo picked up a phone and dialed Fidelity. He explained the call to a portfolio manager, then began contacting ten of the major banks he'd just downgraded, along with another 30 major investors, with a courtesy warning. Much of the same was going on over at the trading desk. Within minutes after the meeting, word had spread across Wall Street. The early reaction was not good. "You don't put a sell on blue chips," one exasperated portfolio manager barked. Cried another: "What's he trying to prove? Doesn't he know you only put a sell on a dog?" Yet another shouted at a sales rep who himself doubted the call, "I can't believe Mayo's doing this. He must be self-destructing."

Many on Wall Street agreed with that assessment. Across town at Warburg Dillon Reed, analyst Thomas Hanley held his own conference call, mocking his rival's downgrade as "Mayo-naise." (Hanley did not return repeated phone calls from FORTUNE.) Still more analysts, including the well-regarded Judah Kraushaar at Merrill Lynch, came to the defense of the banks. Rumors quickly surfaced that a number of trading desks were using photos of Mayo for dartboards. Soon after, CNBC picked up on the grumbling, and reporter Joe Kernan asked satirically, "Do we know whether he was turned down for a car loan?"

No one considered that Mayo might be right.

Indeed, he was right. If his 1994 call identifying the end of the bank slump had been strikingly prescient, his call at the top was the equivalent of hitting a hole in one at the Masters. In his weighty spring report Mayo painted the negative case for banks in sweeping strokes: The merger boom was slowing; efficiencies created by deals were already factored into both earnings and stock prices; many banks were covering up bottom-line weakness with outstretched gains from venture capital, underwriting, and trading; and there was growing evidence of an increase in problem loans. Mayo also hit on another controversial point. The high cost of year 2000–related computer upgrades could stall the sector's growth. On this point he was wrong. Though spending did rise dramatically, Y2K meant little to the banks. But even in error Mayo stood apart. He actually admits he was wrong. On all other counts, his timing was perfect.

POUNDING THE PAVEMENT: *Mike Mayo looks for work.*

Within a month of the call, the sector began a chilling descent, triggered by the interest-rate hikes Mayo had forecast. On Aug. 25, 1999, Bank One issued an earnings warning that chopped one-fourth off the value of the stock—a $15 billion plunge. The immediate culprit was slower growth within its First USA credit card unit. But it was really just the first of what would become a series of missteps related to the 1998 merger of Banc One and First Chicago. On that warning, analysts at Paine Webber, Salomon Smith Barney, and Morgan Stanley Dean Witter lowered their recommendations to either "outperform" or "neutral." Warburg's Hanley also dropped his rating. Privately, Bank One officials were still fuming over Mayo's bearish turn. But by Dec. 21, when the bank had issued another warning and Chairman John McCoy announced his departure, Mayo looked like the oracle of Delphi. The stock had fallen 47% from the top. Even McCoy, who says Mayo was "dead-ass lucky," grudgingly admits the analyst had a point. Says McCoy: "Mayo has strong intellect, and he works hard as hell to understand companies. I respect that."

So did the investors who listened. From its peak on July 7 to the end of 1999, the benchmark S&P bank index sank 21% and closed the year with its worst annual performance relative to the broader market in 54 years. It then continued the tumble through the end of February 2000. "If he hadn't made that sell call, a lot of portfolio managers would have been caught sleeping," says Tom Wynn, manager of the $1 billion Mainstay Convertible fund. Adds Ray Nixon, who manages $4 billion in bank stocks at Barrow Hanley: "That call was one of the reasons Mike Mayo was an analyst I wanted to listen to."

Ironically, the accuracy of Mayo's prophecy seemed to only stir the ire of the various constituencies that felt he had somehow betrayed them. And they gave him hell. Though there were notable exceptions, several large Midwestern and Southeastern banks attempted to cut ties to the analyst. One chief legal counsel at a major regional bank demanded a retraction of the call. The angry CEO of a Tennessee bank told salesmen and investment bankers that he planned to cease all underwriting and trading business with CSFB. A few bank chiefs were equally vocal in phone calls directly to Mayo, chewing him out. Others were subtler in their dissent, simply circulating their opinion that the media-friendly analyst was doing nothing more than reaching for big headlines.

In some cases Mayo didn't even realize the extent of the backlash. On several occasions when the analyst asked to bring an institutional client to sit down with a management team or tag along on the road—a perk granted to many analysts—the banks politely declined. One bank's investor relations manager, who had previously cited the researcher as his favorite, now

whispered to large investors that Mayo's judgment was flawed. Harped the executive: "Why should we help an analyst who doesn't understand our story?"

Still, the most punishing lesson was yet to come. On Sept. 28, 2000, shortly after CSFB announced plans to acquire Donaldson Lufkin & Jenrette, Mayo was called into his research director's office, given some fumbling apologies, and fired. The firm also handed pink slips to seven other members of the banking team. By 4 P.M., Mayo had packed up two dozen cardboard boxes and shipped them off to store in a colleague's garage. He's been out of work ever since. "I knew going negative was a risk," he says. "But just like I was unequivocal on the way up, I wanted to be unequivocal on the way down. I never thought I'd be fired if I got it right."

IT IS HARDLY A DEEP, DARK SECRET THAT THE RATINGS game on Wall Street is beset with serious conflicts. Once kept separate, by long-held convention, from the investment banking side of the business, brokerage house analysts now find themselves in the supporting role of assistant dealmakers. Researchers pull double duty as stock boosters, often serving as liaisons between the companies they cover and the investing public. It is, after all, a game about money. Piles of it. And today the big dollars come from juicy underwriting deals—not from trading commissions, which have fallen steadily over the past decade. That factor has helped turn many high-profile researchers—whose public task, importantly, is *still* to impartially dissect companies and the financial deals they undertake—into "relationship builders."

To solidify relationships with the companies they cover, of course, analysts have mastered the art of saying "I love you," a phrase that translates roughly on Wall Street into "Your stock is worth buying right now." Even during the uncertain, recession-fearing, shoulder-twitching present, more than 70% of the 27,000 analyst recommendations tracked by First Call/Thomson Financial are buys or strong buys. That compares with a minuscule 1% for sell ratings of any kind. Among the ten largest investment banks (which do the vast majority of underwriting), the pattern is more pronounced. First Call identifies a total of 57 sells vs. 7,033 buys. Grumbles portfolio manager Scott Black, president of Delphi Management: "Some companies have to have terminal cancer before they're pulled off the recommended lists."

But while the rewards for positive coverage are well known—and remain an issue of continuing concern for the Securities and Exchange Commission—it has never been obvious (beyond the top-floor corridors of Wall Street) just how stark the penalties could be for being overtly negative. The Mike Mayo case is instructive for just that reason. If a top-rated, thoroughly respected analyst earning a seven-figure salary with a name-brand firm can take this kind of career hit, Wall Street's legions of lower-profile analysts have little hope of summoning the courage to shout "Sell!" on a given stock or sector. The message to retail investors is sobering: If, in fact, stocks are headed for a disastrous slide, you won't hear it from the researchers paid to predict it.

CSFB would not discuss Mayo. A company spokeswoman issued a statement saying the merger with DLJ "gave us the opportunity to bring on board one of the best financial services teams on the Street." CSFB also emphasized the strong relationship that the team, headed by analyst Susan Roth, had with fund managers. In short, his former bosses maintain, Mayo was not fired for being controversial.

However, in interviews with more than a dozen of Mayo's former colleagues at CSFB, Lehman Brothers, and Union Bank of Switzerland as well as investment bankers, bank executives, and research directors at competing brokerages, that is precisely the impression many were left with. Had he simply played the game, had he been more like other analysts, Mayo feels, he'd still have a job. Citing fears of retribution from their employers, fellow analysts, and clients, most spoke with FORTUNE on condition of anonymity. Notably, even some who were targets of Mayo's sharpest criticism were surprised to find the analyst out of work. As the head of one of the nation's five largest banks marveled, "the son of a bitch knows more about research than anyone I know."

Mayo himself seems to have known deep down that his sell call was going to anger many. Though ranked as one of CSFB's top four analysts when it came to generating commissions from institutional clients (who often pay higher trading fees in exchange for an analyst's insight), he knew the real money had long since moved to the underwriting business. And on that front, few areas of the market were more lucrative to CSFB than financial institutions. In 2000, CSFB and DLJ handled bank-related mergers and acquisitions worth a combined $120 billion. At CSFB, investment banking on the whole generated $2.2 billion in revenues in fiscal 1999, the most recent year available. Research didn't even merit its own line item.

True, analysts had a responsibility to deliver stock-picking advice to their moneyed clients, but there were ways to do that without making waves. For starters, when there was a problem with a public company, you could whisper it to brokers who could then whisper it to clients. You could put some cautionary statement like "There is a potential for volatility" in one of the scores of research reports that investment firms publish every year, or lower an outlandish price target. As a last resort, you could

Ratings of Top 10 Brokerage Houses

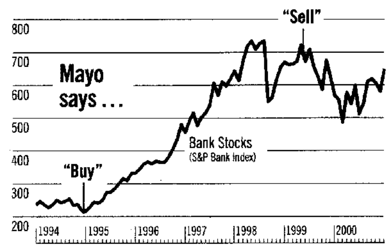
BROKERAGE HOUSE	BUYS	SELLS
Merrill Lynch	940	7
Salomon Smith Barney	856	4
Credit Suisse First Boston	791	9
Goldman Sachs	780	4
UBS Warburg	696	8
Morgan Stanley Dean Witter	670	0
Lehman Brothers	705	8
Banc of America Securities	557	6
Deutsche Banc Alex. Brown	513	9
Bear Stearns	525	2

FORTUNE TABLE / SOURCE: FIRST CALL / THOMSON FINANCIAL

even downgrade a stock to something wishy-washy like "accumulate" or "market neutral," though even that is seldom done. Indeed, you could do almost anything, that is, but actually say the word "sell."

For many analysts, this was simply the cost of doing business. "Think of it this way," says Tom Brown, a former No. 1 banking analyst who says he was fired by DLJ in 1998 for being too negative. "You're making seven figures, and in your heart of hearts you know you're not worth that much. But you don't want to give it up. So why would you ever take the risk of being wrong and pissing someone off?" (CSFB, now merged with DLJ, would not comment on Brown's employment.)

But there was something itching in Mayo to tell the truth—to have research mean something to retail investors who weren't



lucky enough to get the private call. "I guess I'm from the Jerry Maguire school of bank stock analysis," he says, referring to the fictional sports agent who decides to take a stand and loses his job for it. "I wanted to show other analysts that making honest, objective calls that benefit all parties works over the longer term. I wanted to make a statement."

"SCRAPPY" IS A WORD THAT MANY WOULD USE TO DESCRIBE Mike Mayo. You wouldn't be far off the mark with "opinionated" and even "pushy" and "arrogant," according to some who know him well. But one thing is clear: Mayo has always been sure of himself. After earning an undergraduate degree in mathematics at the University of Maryland—paying his tuition with a three-day-a-week job as a computer programmer and salesman for IBM—and then getting his MBA at George Washington University, Mayo sent dozens of résumés to brokerage houses, looking for an analyst's job. But it was late 1987, the time of the market crash, and no one was hiring. So he turned his sights to Alan Greenspan's Federal Reserve, where he spent five years analyzing mergers in the financial services sector. There he learned to dissect deals in ways that are uncommon on Wall Street. Greenspan was intolerant of hedging. Every report had to answer a single, straightforward question: Should the Fed support the deal or not?

In 1992, after another barrage of desperate cover letters and résumés, Mayo finally landed on Wall Street as a junior banking analyst at UBS. He gained a reputation for crisp, well-thought-out arguments that condensed the case for buying or selling into one- or two-sentence bullets on the company's positives and negatives. But often the nuance-free cases he made annoyed those he criticized. Lee Irving, chief accounting officer at KeyCorp, remembers one report Mayo published in the early 1990s that slammed his firm's acquisition strategy. The chief executive was so outraged, recalls Irving, that he threatened to cut off all business with UBS. Eventually, that CEO resigned amid the very problems that Mayo had forecast.

Shortly after Mayo was hired at Lehman Brothers in 1994, he made his electrifying call about the positive turnaround in the banking sector. Helping to fortify his opinions was an exacting financial model that he had developed for determining the underlying value of a bank's franchise. That model not only appeared to predict whether a stock was cheap or expensive but also pointed to likely takeover targets. Though considered mechanical by some, it worked. In April

SIDELINED: *All boxed up and no place to go*

MIKE MAYO

PUMPING IRON, NOT STOCKS: *The analyst hangs tough.*

1995, for example, Mayo picked Barnett, First Chicago, First Commerce, and Chase as acquisition candidates. Within three years all had done deals.

Shortly after, *Institutional Investor* called Mayo one of the "biggest bulls" in bank stocks, later ranking him No. 2 in its annual poll, behind DLJ's Tom Brown. At CSFB, an analyst's rank stood for the firm's credibility, Mayo was told. But credible or not, his uncompromising manner struck several colleagues as simple arrogance. Some were particularly annoyed when the firm's star analyst, often with Trone at his side, issued a report arguing that bank executives should be compensated on the basis of their company's stock performance—or when, in November 1999, he singled out Bank of America for sweetening quarterly earnings with one-time gains and nonrecurring revenue. Their reaction, expressed quietly because Mayo was otherwise a steadfast bull, was that he was talking about issues that were none of his business. He paid little attention to criticism of his unconventional style.

When FORTUNE named him as one of the 15 best researchers last July in our inaugural All-Star Analyst rating, Mayo felt he was having a career season. Though regional banks had just come off a terrible year in 1999, Mayo had been one of only three analysts in his sector whose picks recorded an actual gain for the year. While the analyst remained pessimistic about banks in general, he was starting to see some rare opportunities for investors. In late July 2000, for example, he upgraded Mellon and Bank of New York to a "buy." (Both stocks went on to lead the sector through the end of the year.) Soon afterward, the *Wall Street Journal* ranked him No. 2 in its stock-picking poll, and then *Institutional Investor* came out with its 2000 ranking. Mayo finished second, behind Goldman Sachs' Lori Appelbaum. In third place was Susan Roth, a relative unknown from DLJ who had been among the analysts to reiterate buys on stocks that Mayo had downgraded in 1999.

The message to investors is sobering: If, in fact, stocks are headed for disaster, you won't hear it from the analysts.

Internally, CSFB was having a banner year in financial services transactions, handling deals for Wells Fargo and U.S. Trust, among others. DLJ ranked close behind. But at the latter, say one current and one former employee of the firm, analysts were expected to open doors for the banking team. Veteran dealmaker Richard Barrett, who led the team, had been accused publicly of being behind the firing of Tom Brown in 1998—a charge he later denied. Years earlier, similar accusations had been made surrounding the departure of another outspoken analyst, Charles Peabody, from UBS when Barrett ran the banking group there.

While CSFB would not make Barrett available for comment, it is clear that the firm's banking clients saw absolutely nothing wrong with having an analyst in their corner. "Dick Barrett knew that if we were doing a deal and an analyst didn't recommend our stock, we probably wouldn't use that firm," says one senior bank executive, who has done several deals with Barrett and respects his abilities. "I'm going to hire the firm with the analyst who likes my stock."

How much this sort of analysis figured into CSFB's decision to fire Mayo isn't clear. (CSFB insists that Barrett was not a factor.) In November, Barrett told the industry publication *U.S. Banker* that Susan Roth was retained over Mayo simply because she was a better analyst. What is certain is that when the CSFB/DLJ merger was announced on Aug. 30, almost no one thought Mike Mayo had a chance—and that wasn't because his picks had been wrong.

Indeed, the one obvious call that Mayo seemed to blow was the one regarding his own career. The evening that news broke about the deal, Trone called Mayo and asked him if the two should start looking for work. "Don't worry, we're safe," Mayo told him, laughing at the suggestion. "Look at the year we've been having!" But as the weeks passed, the two became suspicious. They'd heard rumors that Roth and her group were lobbying hard for the banking slot. As for Barrett's future, that seemed assured: He would assume control of the merged financial institutions group, and with it one of the most powerful moneymaking positions in the firm.

Mayo, too, had a team, but no one interviewed them. When Mayo pressed research director Jack Kirnan and Kirnan's boss Al Jackson, the response was that nothing had been decided. It wasn't until an aggressive headhunter called Trone at the office and told him the DLJ team had contracts in their hands that Mayo finally realized what was happening.

BEAR MEETS BEAR:
His big-bank worries remain.

research director at this one firm, and he wants a writing sample. Can you believe that? I've got to give him a writing sample! It's like I'm back where I was when I started in this business." Although CSFB didn't exactly leave him poor, offering a generous severance package, the top-ranked analyst has been worried about being sidelined from the game too long. And by now Mayo is entering month No. 4 of his unemployment. Several smaller firms had initially expressed interest in hiring a big name to boost their aspiring research units, though none have made an offer. There's also been interest among a variety of hedge funds that tend to value critical research. Among the bulge-bracket firms, however, no one has so much as bitten.

Mayo says he isn't giving up. He just has to be in the game, he confides. When he's playing with his 6-month-old daughter on the living room floor, he finds himself dialing into conference calls. In fact, to stay abreast of the sector, he's been paying his own way to bank conferences in Boston, Charlotte, N.C., and New York. He's also taken investors with him to meet senior management at Wachovia in Winston-Salem, N.C., and SunTrust Banks in Atlanta, two banks he has maintained good relationships with despite his sell call. What's more, there's still plenty to shout about in the banking industry. Fourth-quarter bank earnings are sure to look awful, he insists. Already, Chase and Bank of America have lowered estimates. There is talk, too, of problem loans at several institutions.

But the months of pounding the pavement, of 30 unsuccessful job interviews at a dozen firms, are taking a toll. He's had to swallow hard and call former competitors to inquire about openings. Most have been nice enough about it, with some suggesting that he switch to the "buy side" of Wall Street, working for a mutual or hedge fund. The mere thought of this is enough to raise his hackles. He believes such a career change is equivalent to admitting defeat. What frustrates Mayo even more is the fact that his replacement at CSFB has relaunched coverage of bank stocks with an argument that seems to mirror his own views. Likewise, she's concerned that banks will be vulnerable to soaring corporate bond defaults and a slowdown in loan growth. She's worried about their lackluster revenue and deteriorating credit quality. Indeed, of the 20 big banks she covers, she expects eight to report a decline in fourth-quarter earnings—three of them by more than 30% over the previous year.

That's why there isn't a "sell" among them.

"You're making seven figures," confesses one analyst. "So why would you ever take the risk of pissing someone off?"

On Sept. 15 he pleaded to Kirnan for information. Kirnan conceded that things did not look good. Mayo threw up his hands, and with them went a stack of papers. He flung a pen across the room. After returning to his office and composing himself, he looked over his calendar for the next day. On the agenda: an 11 A.M. talk with CSFB trainees about, of all things, how to downgrade a stock. Mayo resolved to lobby like the DLJ analysts and also to put up a brave front. He spoke to the trainees the next day, overflowing with emotions as he had back on May 24, 1999. "Look at me," he told the group. "I'm evidence that you can be negative and still survive."

IT'S A FRIGID, SNOWY JANUARY EVENING IN MANHATTAN, and Mayo is sprinting past the doorman of his Upper East Side high-rise and into a Starbucks across the street. "Sorry I'm late," he says, out of breath. "I've been trying to get a meeting with the

ACCOUNTING REFORM AND INVESTOR PROTECTION

WEDNESDAY, MARCH 20, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:20 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

This morning, we continue in our series of oversight hearings on the systemic issues surrounding the issues of accounting practices and investor protection.

Last week, actually, we had an interesting panel with representatives from the accounting industry. This morning, we are very pleased that we are going to hear from a variety of interested parties, including the Consumer Federation of America, the Council of Institutional Investors, the Association of Investment Management and Research, and the AFL–CIO.

We have been reviewing in the Banking Committee a number of important issues—auditor independence, the setting of auditing standards, disclosures, conflicts of interest, SEC authority and funding, corporate loans to executives and insider abuse, corporate governance, self-regulatory structure for accountants.

Each of the groups represented here today have held in some instances pronounced views on these issues that we have under consideration and we very much welcome this panel being with us.

I will introduce each person as we go. We will hear from all four before we do any questioning.

First, we will hear from our former colleague, the very able and distinguished Senator from Ohio, Howard Metzenbaum, who served here with us in the Senate for 19 years, and is now the Chairman for the Consumer Federation of America, a pro bono assignment, as I understand it.

We wouldn't expect anything less from Howard Metzenbaum.

CFA is a nonprofit educational and consumer advocacy organization. Its membership consists of more than 285 organizations throughout the country, with an estimated membership in excess of 50 million people.

Howard, we are delighted to have you with us and we would be happy to hear from you.

STATEMENT OF SENATOR HOWARD M. METZENBAUM (RET.) CHAIRMAN, CONSUMER FEDERATION OF AMERICA

Senator METZENBAUM. Mr. Chairman, I am delighted to appear before your Committee. When I was here, I always enjoyed working with you and considered you a friend. We made trips together and it would not feel proper or appropriate if I did not, on behalf of myself and my wife, send our best regards to your wife, Christine.

Chairman SARBANES. Thank you.

Senator METZENBAUM. It is truly a privilege to be here with you today speaking for the Consumer Federation of America.

Chairman SARBANES. Howard, would you just suspend your statement for a moment.

I am sorry, Senator Akaka. Did you have an opening statement?

Senator AKAKA. Yes, Mr. Chairman. Thank you very much.

Chairman SARBANES. You are recognized.

STATEMENT OF SENATOR DANIEL K. AKAKA

Senator AKAKA. I want to add my welcome to our former colleague, Howard Metzenbaum, and to all of you here.

I just want to tell you as a Member of this Committee, I have a different perspective. I see things from the side.

[Laughter.]

Chairman SARBANES. It is known as covering all your bases.

[Laughter.]

Senator AKAKA. Thank you so much for being here.

Without question, your being here and your statements will be useful to the Committee.

Investors planning for retirement are faced with a complicated set of financial decisions that will significantly impact their future financial security. The shift from defined pension benefit plans to 401(k) contribution plans has placed additional financial decision-making responsibilities onto the employee.

The 401(k) plans have the potential for greater returns and more money during retirement. But they come with additional risks that need to be managed properly. False or misleading information provided by companies, auditors, or stock analysts has the potential to result in losses which will destroy retirement savings.

You might wish to comment on the possibility that the Administration may be dipping into our Thrift Savings Plan, TSP, funds.

Enron has demonstrated the need for additional accounting and investor protections to ensure that investors have the necessary information that they need to make sound financial decisions.

Mr. Chairman, we must also secure the funding level necessary for the Securities and Exchange Commission, to enforce the regulations intended to protect investors.

According to the General Accounting Office, GAO, approximately 250 positions were vacant last year because the Commission was unable to attract qualified candidates. Additional funding will be necessary to attract and retain employees.

I just held a hearing yesterday on human capital. At the hearing, we discussed personnel shortages that the Federal Government will be facing. If the Congress does not address this issue, the Federal Government may soon face a national emergency. We have to plan for that and recruit and retain people. There has to be enough re-

cruitment incentives to get them to come and work for the Federal Government.

Mr. Chairman, I look forward to hearing your recommendations for reform and to the recommendations of our witnesses.

Thank you very much.

Chairman SARBANES. Thank you, Senator Akaka.

Senator Metzenbaum.

Senator METZENBAUM. Thank you very much, Mr. Chairman, Senator Akaka. It is good to see you again and I am so pleased to see you here this morning.

Chairman SARBANES. Thank you.

Senator METZENBAUM. I enjoyed serving with you when we worked together in the Senate.

As a matter of fact, I spent my career in the U.S. Senate working to prevent corporations from running roughshod over the rights of consumers and workers. I have to tell you that I have never seen a more appalling example of heartless, unfettered corporate greed than in the Enron debacle. This company lied to their investors, lied to their employees, hid crucial information about their finances, and tried to improperly influence Government officials. And in criminally indicting Enron's auditing firm, Arthur Andersen, the Department of Justice has said that it believes that Andersen was a party to this massive deception.

What kind of response to this wrong-doing have we gotten from the accounting industry? Is the industry going to support meaningful reforms so that investors and the public will regain confidence in corporate financial statements and in participating in stock market investments?

As they say in the rental car commercials, not exactly.

Last week, the accounting industry kicked off a multi-million dollar advertising campaign opposing significant reform. For shame. Of course, they try not to come right out and say so.

In essence, what their representative told the House last week is that they are 100 percent behind efforts to increase investor confidence in financial disclosures, just as long as they do not have to make any real changes in the way they audit public companies. That is not good enough. The American people are demanding that the accounting industry face up to their responsibility, not run slick advertising campaigns designed to stop real reform.

To understand why real reform is absolutely necessary, you have to understand the extent of the failure that occurred. The disturbing fact is that as in the case of many other blown audits that cost investors billions, all the safeguards designed to protect investors failed and failed miserably.

Most importantly, the auditors failed. They signed off on financial statements that did not present an accurate picture of Enron's finances, signed off on statements that were inaccurate. The Financial Accounting Standards Board failed. They did not require that companies divulge information that would present a complete financial portrait. The Enron corporate board failed to ask management tough questions, challenge questionable practices, and require more transparent disclosure. The credit-rating agencies and the security analysts who are supposedly the outside experts that

investors can rely on failed to provide any advanced warning of possible trouble.

The ultimate failure, however, was two-fold: Congress and the Security and Exchange Commission.

The real story out of the Enron disaster is not that its corporate managers went to great lengths to hide the company's indebtedness and artificially inflate its earnings. Our system was designed with just that behavior in mind. The real story is that Congress and the SEC stood on the sidelines and watched as laws and regulations designed to keep auditors independent and corporate managers honest were eroded and undermined. They were snookered by an accounting industry that claimed that oversight and self-regulation would protect investors, employees and the public.

In 1995, for example, Congress passed the Private Securities Litigation Reform Act. Sounds good. But significantly undermine the ability of investors to go to court to deter wrong-doing by companies and their auditors. I am happy to say that I did not vote for that law. I left the Senate 1 year too soon to oppose it.

Clearly, the system is broken and it is Congress' job to fix it. In my written testimony, I propose a comprehensive package of reforms to do the job. What I would like to do today is to highlight the single most important step that Congress can take—restore integrity to the independent audit. To accomplish this, it must enhance auditor independence, provide effective regulatory oversight of accountants, and restore the threat of private litigation as a strong deterrent to wrong-doing.

The whole point of requiring public companies to obtain an independent audit is to ensure that outside experts have reviewed the company's books and determined that they not only comply with the letter of accounting rules, but also present a fair and accurate picture of the company's finances. Auditors have profited handsomely over the years from performing this important public watchdog function. Unless the auditor is free of bias, brings an appropriate level of professional skepticism to the task, and feels free to challenge management decisions, you might as well let the company certify its own books.

The independent audit is arguably more important today than it has been at any time since the requirement was first imposed in the 1930's. More than half of all American households today invest in public companies, either directly or through mutual funds. They do so primarily to save for retirement.

As a result, their financial well-being later in life is dependent on the integrity of our financial markets.

At the same time, corporations today are under great pressure to keep their stock prices on a smooth upward trajectory. This gives corporate managers a strong incentive to manage their earnings in order to present the picture of a steadily rising profitability that Wall Street enjoys. To do that, they need an auditor who is willing to turn a blind eye to their overly aggressive accounting. The less independent the auditor, the more compliant they are likely to be.

Many factors have undermined auditor independence. First, most of the big firms have dramatically increased their sales of consulting and other nonaudit services to their audit clients, despite the clear conflict of interest that this creates.

I might say, parenthetically, Mr. Chairman, that before I came to the Senate, I was active in the business world. I was on a substantial number of corporate boards, some of which were on the New York and American stock exchanges and over the counter.

I do not remember any instances in which consultants were brought in. There may have been some minor instances in which consultants were brought in by the auditors. But in the main, auditors were used for auditing purposes, to relate the facts and details as to the profit and loss of the company and what its financial stability was and what its capital structure was.

But this development, I think, mostly in the last 10 years, of bringing in consultants, has really made the consulting part of the accounting industry become the major factor as far as producing income is concerned. And as a consequence, I think it has been a bane as far as getting the proper kind of accounting that the public are entitled to.

Today, virtually all of the big companies receive both audit and nonaudit services from their accountants and they typically pay between two and three times as much for the nonaudit services as they do for the audit itself.

So if an auditor's tough questioning of the management were to threaten its more profitable consulting arrangement, that auditor might very well expect to face tough questioning of his own from higher-ups at his own firm, or her own firm.

Lack of independence involves more than just consulting, however. It starts with the fact that auditors are hired, paid, and fired by the audit client. This basic conflict is exacerbated by the general lack of client turnover. Auditors may reasonably expect to keep the same client for 20, 30, even 50 years.

Also undermining auditor independence is the revolving door that all too often exists between auditors and their audit clients. This was true at Enron. It was true at Waste Management, and it is a common feature in many failed audits. A constant flow of personnel from the auditor to the audit client helps to create an environment in which external auditors are viewed as just another part of the corporate family. Such intimacy is not conducive to true independence.

Congress has an interest and an obligation to put a halt to this all-too-close relationship. Half-measures and phony reforms will actually harm investors and the public by creating the illusion of independence where none exists.

If Congress only does one thing this year to prevent more Enron-like catastrophes from occurring, it must be to guarantee that audits are truly independent. The first step in guaranteeing a completely independent outside audit is to ban accounting firms from providing auditing and consulting services to the same client. And I want to emphasize that. I think it is imperative that Congress act to ban accounting firms from providing auditing consulting services to the same client.

Accounting firms got along very well for many years without the consulting function. It is only within the last 10 years, as I previously mentioned, that this whole consulting facet has developed.

Certainly narrowly defined services could be exempted by the SEC on a case-by-case basis, but only if it shows that these services

enhance audit quality and benefit investors and only if they are directly and separately approved by the audit committee or by the board.

A ban on nonaudit services should be accompanied by the periodic rotation of auditors, an idea that has gained some highly credible backers. An audit firm that knows it has a limited term of engagement has significantly less to lose by challenging management than one that expects to retain the client indefinitely.

Because such an approach would significantly enhance auditor independence, we believe the benefits far outweigh the costs. One proposal that deals with this issue is the legislation proposed by Senators Dodd and Corzine, which requires a study of mandatory rotation. The Dodd–Corzine bill has a number of positive features, but we think a strong case can be made for requiring mandatory rotation, not just studying it.

Finally, to close the revolving door between audit firms and their audit clients, there should be a 2 to 3 year cooling off period after their involvement and the audit has ended, during which members of the audit team and their supervisors would be prohibited from seeking or accepting employment with a former audit client.

We also believe that Congress must provide effective regulatory oversight of accountants. If auditors face numerous pressures to sign off on questionable accounting practices, they face relatively little fear of sanctions if they do.

The current regulatory system is underfunded, inefficient, and a captive of the industry. A complete overhaul is definitely needed. Whether the SEC is given enhanced oversight responsibility or a new regulatory body is created, that regulator must be independent of the accounting industry. It must be adequately funded and have strong rulemaking, standard setting, investigative, and enforcement authority.

The private litigation laws also must be reformed to provide a real deterrent to wrong-doing. Private litigation has long been viewed as an important supplement to regulation, since the threat of having to pay significant financial damages provides an incentive to comply with even poorly enforced laws.

In 1995, however, Congress passed the Private Securities Litigation Reform Act, which significantly reduced auditor's liability in cases of securities fraud. It did so both by making it more difficult to bring a case against accountants and by reducing their financial exposure where they are found to have contributed to fraud.

The result is that the threats of private lawsuits now poses a diminished deterrent to accounting fraud. Restoring reasonable liability for culpable accountants should be part of any overall reform plan. At a minimum, this should include provisions: To enable plaintiffs to gain access to documents through discovery before having to meet the heightened pleading standards regarding state of mind; to restore joint and several liability where the defendant recklessly violated security laws and the primary wrongdoer is bankrupt; to restore aiding and abetting liability for those who contribute to fraud but are not the primary culprit; and to extend the statute of limitations for securities fraud lawsuits.

In conclusion, let me say that the collapse of Enron has provided a clarion call for reform. It has exposed gaping holes in the investor

protections we rely on to keep corporate managers honest. Enron is not unique and only a comprehensive set of reforms will prevent future Enrons from happening.

As I said at the beginning of my comments, such a far-reaching approach must focus on enhancing the independence of the audit, providing effective oversight of the accounting industry, and ensuring that, when all else fails, the threat of private litigation will deter wrong-doers.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Metzenbaum, for a very comprehensive and helpful statement.

Next, we will hear from Sarah Teslik, the Executive Director of the Council of Institutional Investors.

The Council of Institutional Investors is an organization of over 100 public and private pension funds that seek to address investment issues affecting the security of its members' $1.3 trillion in assets. Prior to the formation of the Council, and becoming its Executive Director, Ms. Teslik was a corporate and securities attorney with the law firm of Wilke, Farr & Gallagher here in Washington.

Ms. Teslik, we would be very happy to hear from you.

STATEMENT OF SARAH TESLIK
EXECUTIVE DIRECTOR
COUNCIL OF INSTITUTIONAL INVESTORS

Ms. TESLIK. Thank you. I know you are Enron-exhausted, so I will start with the bottom line.

The very bad things that we have seen happening at Enron and everywhere else happened because we let them. Even honest people begin behaving badly when they realize there are no consequences. And there are essentially no consequences for corporate crime and essentially no consequences when boards, CEO's, auditors, analysts, and others merely behave badly.

When the upside is a few hundred million dollars to keep, people will behave badly when there are no consequences.

Why are we seeing more frauds today than we used to? For a reason that I think is largely missed in the press, and that is that ever since the laws were passed 65 years ago to protect investors, special interests have been eating away at them, quietly but gradually, so that now the laws in place, which, in theory, are there to protect investors, in fact, protect the other side.

I will give you some examples in a minute.

Typically, over time, great civilizations have crumbled when special interests have been able to get a hold of the government machinery. And I know of no better example than what has gone on in our investment sector over the last 65 years. If history is any guide, you are all being pressured right now to give in, keep the system the way it is. Also if history is any guide, you will give in. I am here to beg you not to.

What must be done? Let's start with the auditors, even though I think they are a sideshow, and let's start with what is wrong.

Right now, auditors are picked by the managers whose books they have to review. If fifth graders picked their teachers, fifth graders would get A's. Not only that. Auditors, and the people who have to produce financial statements, write the standards they

have to follow to make those statements. If fifth graders wrote grading standards, all fifth graders would pass. Not only that. We allow auditors to oversee and police their own profession. You know better than that. No profession ever self-polices effectively.

What should you pass? I have a list of suggestions in my written testimony. You have heard them in a variety of permutations and have seen them in just about every bill imaginable. But, in essence, you need to focus on legislation that aligns the financial interest of auditors with investors. Many people invariably act in their self-interest. You cannot rely on honor or professionalism. Chinese walls never work. Independent bodies never remain independent. Unless you harness self-interest, you will keep getting misleading financials.

I know I am unusual in the people testifying in front of you to say that auditors are a sideshow. They are very important. But they are a sideshow. Auditors review the books. It is not the auditor's job to run the company. It is not the auditor's job to have put in place the ethics policies. It is not the auditor's job to make money, to produce secure jobs, to say no to CEO's who want loans of $341 million when they are already rich. That job belongs to the managers and it belongs to the board. It is their job to prevent fraud in the first place and you need to focus on them.

Why is it that boards turn a blind eye? There is an easy answer here. What if Senate staffers picked Senators? Would you stop your staff if they were stealing? I doubt you would.

Currently, boards of directors are picked by managers, not by shareholders. Therefore, they protect managers rather than protecting shareholders. As long as that system is in place, that result will be in place.

I know that the Council is known to be a shareholder advocate and it is sometimes assumed that we are out in left field when we make suggestions that the system is broken. I would like to give you a few examples of existing laws that protect managers and boards rather than shareholders, so you can decide whether I am the crazy one or whether the system is broken. Eight quick ones.

One, if a shareholder buys a mere 5 percent of a company, he or she has to file forms as if the Government were tracking a pedophile, not an owner. Why don't shareholders file these forms? Instead, they take the second option, which is, if you promise the Government that you will be inert, you can file a simpler form.

Two, the Government also tells us what issues we can discuss with managers. I am not making this up. The SEC decides what issues we can raise for a shareholder vote and what issues we cannot. Have any of you read those rules? They pretty much take everything off the table. We cannot ask about anything that is "ordinary business"—which covers anything that we ought to ask about.

We also cannot ask about anything that is extraordinary business if it only affects a small part of the company. We cannot ask anything about the current board of directors, the single thing to which we should pay the most attention. Many of the issues raised by Enron we cannot ask about through shareholder vote because the SEC won't let us.

Three, if we get through the SEC hoop and we figured out an issue that they will let us raise with our own employees, corporate managers, and it gets on the ballot, the SEC requires us physically to go to the meeting. Even though most companies do not require their directors to go to the meeting and most shareholders do not go to the meeting. So if you do not have a lot of money, if you actually have to go to work in the morning, if you are disabled or cannot travel, forget it.

Four, not only that—if the company knows you are coming and they know you are going to ask a question they do not want to hear about, they can move the meeting to a place you cannot get to. U.S. companies have held their annual meetings in Russia. They have held them in towns in Alabama, without airports, on Friday afternoon at 5:30, before a holiday weekend. They move meetings when they know we are coming. They are allowed to.

Five, if the managers who are counting the ballots realize they are going to lose, they can call off the vote on the meeting day, and they have done so.

Six, if a shareholder actually wins, if we have gotten through the first five things and we actually win the majority of the votes cast, the managers can ignore it as if it did not happen. And virtually all of them do, some of them, year after year after year.

Seven, shareholders used to get to vote on boards of directors every year, once a year. Now if you look at the Comcast and AT&T merger, they have packaged into the merger a provision that says that we cannot vote on the directors again until 2005, even if, presumably, Enron-like facts emerge. We are out of luck.

Finally, shareholder elections in many cases are rigged. If shareholders do not vote, unbeknownst to them, their brokers can vote for them for management. There are studies documenting that this throws elections.

With rules like that in place which protect managers and boards rather than shareholders, it is no surprise that we are unable to do anything about the Enrons of the world on our own.

So what legislation do you pass if you want to risk your reelection funding and fix the problem?

First, we need better and immediate information about executive compensation packages and about CEO's buying, selling, hedging, and lending habits. This does not sound like the kind of recommendation you have been getting from a lot of people who have been testifying here, but it is actually critical to the process.

Why? Because unless CEO's and boards can have stock option packages which allow them to get hundreds of millions of dollars out of the companies, they cannot turn companies into Ponzi schemes. Unless they can get the money in, fake the financials, take enough out quickly enough before the company crashes, the money's not in it for them. You have to get at the money.

Second, Senator Nelson's bill has a number of issues that we think are worthy of addressing. We have had a rulemaking pending at the SEC for about 4 years, asking that directors' conflicts of interest be disclosed. We find it a significant pattern at companies with major accounting fraud, that directors have undisclosed conflicts of interest. There is no excuse for failure to disclose every significant or nontrivial conflict of interest a board member has. It

is an easy thing to implement. We have not even received a little postcard back from the SEC to say, “got rulemaking.” We are out of stock.

Third, Senator Nelson’s bill also gets at the independence board issue very well. And unlike many bills, it uses a definition of an independent director that makes sense. It is one that essentially provides that a director is independent only if his or her board seat is their connection to the company.

At our meeting next week, we will be discussing legislative language to submit to you which would allow shareholders, if a large percentage agreed, to submit board candidates that the company would have to run on the company’s proxy. Ultimately, if we cannot select directors, we cannot fix these problems.

Corporate governance, in short, should be at the center of your legislative debates, not at the periphery. Structures that stop fraud in the first place, rather than structures that deal with it once it has gotten on the auditor’s desk, are the way to deal with fraud. We need both, but we need you to not neglect the governance.

A final word on enforcement. There is too little enforcement in general and there is way too little enforcement that targets individuals. When the hubbub of Enron dies down, it is 5 years from now and you are an auditor and you are sitting at a conference table privately with the CEO who is going to pay your fee. And the CEO wants you to do something that makes you uncomfortable. Which will deter you more? The notion that your employer may eventually pay a fine? Or the notion that you may go to jail?

There is no comparison. Fines victimize the victims. We the shareholders pay them. You need to go after the individuals. We applaud the Leahy–Daschle bill in that regard and any other efforts to focus on the people who you can, in fact, deter. One CEO or one director, not a mid-level scapegoat, that goes to jail would be a corporate governance shot heard around the world.

Thank you.

Chairman SARBANES. Thank you very much.

We will now turn to Thomas Bowman, who is President and CEO of the Association for Investment Management and Research. He has been the President since 1994.

The Association for Investment Management and Research is an international nonprofit organization of more than 50,000 investment practitioners and educators that educate and examine investment managers and analysts. They run the chartered financial analyst program.

Before joining AIMR, Mr. Bowman was President and CEO of DP Asset Management in Wilmington, Delaware, and previously Vice President and Chief Investment Officer at Frank Russell Investment Company in Tacoma, Washington.

Mr. Bowman, we are pleased to have you here this morning.

STATEMENT OF THOMAS A. BOWMAN, CFA PRESIDENT AND CHIEF EXECUTIVE OFFICER ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH

Mr. BOWMAN. Thank you, Chairman Sarbanes, Senator Akaka, and other Members of the Committee, for the opportunity to speak

on behalf of the 150,000 investment professionals worldwide who are AIMR members or candidates for the CFA designation.

Most AIMR members are not subject to the majority of conflicts of interest facing research analysts working for Wall Street brokerages and similar firms worldwide. But all investors, not just investment professionals, are disadvantaged by lack of transparency and of disclosure in corporate financial statements, unreliable audit reports, and deficiencies in corporate governance.

In today's written testimony, we address a number of investor protection issues: The adequacy of accounting standards. The effectiveness of the SEC oversight. The importance of a high-quality corporate governance framework and the role that institutional investors should play to protect their clients' interests.

In my oral remarks, however, I wish to focus on the issues of independence of two respected professions: Auditors and analysts. In particular, allegations that analysts lack independence, issue biased reports, and make recommendations without a reasonable basis are important to us because they cut to the heart of our ethical principles and taint a proud profession and its practitioners. We want to share with you our recommendations for reform.

AIMR has been quite vocal in advocating changes in regulations and oversight of auditors so that they can regain their lost independence and become more vigilant watchdogs. We believe these changes are needed if investors are to regain confidence in the audit process, and ultimately, in the information provided in corporate financial statements.

Audit firms are not obligated to provide business advisory and other nonaudit services to their audit clients. They choose to do so because there are strong economic incentives. As a result, accounting professionals face conflicts of interest and are often put in the position of auditing their own firm's work. We recommend that audit firms stop providing those nonaudit services that present insurmountable conflicts, and retain only those that may improve the effectiveness of the audit, such as tax preparation.

If audit firms are permitted to provide nonaudit services to audit clients, they must manage the resulting conflicts more effectively, and ensure that they never lose sight of their primary purpose—to attest to the fairness of the financial statements, providing needed assurance to shareholders and investors.

In our written testimony, we make several recommendations for managing auditor conflicts. The only one I will mention here is our proposal that full disclosure of these conflicts be required in the clients' financial statements, including the types of nonaudit services provided and the related fees.

It would be inappropriate of us to discuss auditor conflicts of interest without acknowledging that some investment professionals, specifically Wall Street research analysts, also face conflicts in conducting research and making investment recommendations.

At the start, it is important for me to tell you that analysts, like auditors, work in conditions of uncertainty. They gather and analyze corporate financial and other information of varying degrees of transparency and use that information to forecast a company's future prospects. And even when analysts have the benefit of full and fair disclosure, financial analysis remains more art than science.

No analyst, no matter how independent and objective, has a magic formula that accurately and consistently predicts stock prices.

To do the best job they can, analysts need an environment that fosters their objectivity. To create that environment, we must recognize and address all sources of pressure and implement effective processes to manage each of them. The existing pressures create an environment that challenges the integrity of those who work within it, undermining the ethical principles upon which AIMR and its CFA program are based.

Two conflicts, investment banking collaboration and personal investments, are fully within the capacity of firms to manage. I will address these conflicts today. Others—arising from issuers, from institutional clients, and from human nature—are not. But they must also be addressed, if analysts are to be truly free from coercion or enticement to bias their reports and recommendations.

Regarding investment banking: We do not dispute that any collaboration between research and investment banking is fraught with ethical conflicts. However, we understand that, in the current structure, collaboration is critical to a firm's due diligence in evaluating investment banking clients and may provide synergies within the firm.

The question then becomes how analysts should be rewarded—according to what criteria? We strongly believe that firms can, and must, reward analysts first and foremost for the quality of their analysis and the reliability and success of their recommendations, and not their contributions to investment banking or other corporate finance activities. We must align analysts with investor interests, not with investment banking interests.

With respect to personal investments and to trading, we do not believe that permitting analysts to invest in the companies they follow is inherently unethical as long as strict rules are in place to ensure that client interests come first. Indeed, some would argue that such investments better align analysts and investing client interests. To manage these two conflicts more effectively, we make the following recommendations:

First, compensation is key. Firms must not link analyst compensation directly to the success of investment banking activities, but rather, directly link, and heavily weight, compensation to the quality of the research and recommendations. Firms must have explicit quantitative measures for the performance of stock recommendations and the accuracy of earnings forecasts.

Second, firms must foster a corporate culture that protects analysts from undue pressure from, and retaliations by, issuers or others. Firms cannot control the behavior of others, but they can have an impact on how their employees react to that behavior.

Third, firms must constantly communicate to clients and the investing public the measures in place that ensure analysts are independent and their reports and recommendations have reasonable and adequate bases.

Fourth, firms must have reporting structures that prevent investment banking or corporate finance from reviewing, approving, modifying, or rejecting reports or recommendations.

Fifth, firms must have clear, strict, and enforced policies and procedures for personal investment and trading that ensure inves-

tors' interests come first, prevent analysis from either the front running clients or their firms, and from trading against their recommendations.

Sixth, firms must require analysts to provide full disclosure of conflicts in reports and media appearances. The disclosures must be prominent, specific, and in "plain English," not marginal and boilerplate.

At a minimum, analysts and their firms should disclose: Personal and firm investment holdings. Directorships on company boards. Compensation received by the firm from the subject company and the nature of the relationship. And material gifts received by the analyst from the subject company or the firms' investment banking or corporate finance departments.

Seventh, firms must require timely, regular updates or reconfirmations of recommendations under normal circumstances, and more frequently in periods of high market volatility.

Eighth, firms must not quietly and unobtrusively discontinue coverage or move a security to a "not-rated" category—such action does not serve investor interests—but must promptly issue a final report with a reason for discontinuance.

Finally, an overhaul of securities' rating systems is needed. Although firms may believe their proprietary rating systems are a competitive advantage, the market is better served when ratings are concise, clear, and easily understood by the average investor and provide reasonable comparability across firms.

Therefore, we recommend that all ratings have three elements: One, the recommendation itself. Two, a risk measure. Three, a time horizon. We believe that a rating that incorporates these three elements will help address the current tendency to overemphasize short-term price performance.

As you know, today, investment analysts and fund managers are prime-time news. Their recommendations, primarily likes rather than dislikes, are delivered in 30-second sound-bites. The message this communicates is that the serious business of investing is a sport, like horse racing, where investors should always be looking for hot tips.

Ideally, we would prefer that investors could always purchase and read the full research report to understand the risks and rewards of a particular investment before investing, we know that this is not realistic. We hope that by expanding the rating and communicating all three elements in media appearances as well as reports, investors will have better information by which to judge the suitability of the investment to their own unique circumstances and constraints.

In closing, I would like to impress upon the Committee that we appreciate not only the seriousness, but also the complexity of the problems facing Wall Street analysts. A precipitous solution that addresses only one aspect of the problem is not the answer. However, we believe that the profession itself can address these issues, and recommend effective solutions that can be implemented by the affected firms. Let me assure you that AIMR is already working diligently toward these ends.

I will be happy to answer any questions later. Thank you.

Chairman SARBANES. Thank you very much, sir.

Our concluding panelist this morning is Damon Silvers, Associate General Counsel of the AFL–CIO. Mr. Silvers was previously the Assistant Director of the Office of Corporate and Financial Affairs for the Amalgamated Clothing and Textile Workers Union, and has been the Research Director for the Harvard Union of Clerical and Technical Workers.

Mr. Silvers, we are pleased to have you here this morning. We would be happy to hear from you.

STATEMENT OF DAMON A. SILVERS
ASSOCIATE GENERAL COUNSEL
AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. SILVERS. Thank you very much, Senator.

I am, as you said, the Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. On behalf of the AFL–CIO's 13 million members, our 62 member unions, we wish to thank you, Senator Sarbanes, and this Committee, for taking up this vital issue on the heels of the collapse of Enron and the similar problems that have arisen at companies like Waste Management and Global Crossing.

Corporate governance is a web of relationships. These relationships should work toward getting companies to make smart, long-term, focused decisions that lead to sustainable benefits for all who participate in the company. Unfortunately, Enron is a window into a set of pervasive conflicts of interest that defeat the purposes of corporate governance and that threaten the retirement security of America's working families, as Senator Akaka alluded to in his opening remarks.

At Enron, the management, the board of directors, the outside auditors and the Wall Street analysts all failed to protect investors. And similar events have both preceded and accompanied Enron's collapse at companies like Global Crossing, Cendant, Waste Management, McKesson, and many, many more. The source of these failures lie in the unregulated conflicts of interest that permeate the relationships between the management of these companies and the people who were supposed to be protecting investors.

I will just note here that the AFL–CIO, which is a member of the Council of Institutional Investors, fully shares the analysis that you have heard about the board-focused problems that Sarah Teslik just spoke about.

The AFL–CIO's member unions and their members urge that this Committee take up the task of crafting comprehensive legislation to take on the conflicts of interest in the capital markets and the board rooms of America's public companies. You have heard in prior hearings from those who have benefited from and continue to benefit from these conflicts as to why they must be allowed to continue, from those who would lull you to sleep with the lullaby that everything will be all right if you just do nothing. Now that may be the view from the lobbyists' offices on K Street that do the heavy lifting for the accounting industry here on the Hill, but it is not how things look from the homes of thousands of working families in Houston, Texas, Portland, Oregon, and Rochester, New York, who have lost their retirement savings and, in some cases,

their jobs and their health care because they believed what they were told, told by the experts, told by the people who had duties to them, told by the people they trust, by their employers, by their employers' accountants, and the analysts that interpreted the accountants' numbers.

I will also add that although not everyone suffers so acutely as these people that I have referred to, that literally tens of millions of working families have had money taken out of their retirement savings by the events at Enron and other companies that we have been discussing today.

Let me address what a comprehensive reform package requires.

Corporate governance, as Sarah Teslik said, starts with boards of directors. Public company boards need strong independent directors who are accountable to investors. Key to what happened at Enron was that Enron touted directors as independent who really had significant ties to Enron's management, ties that in many cases were not disclosed.

Investors first need complete disclosure of all ties between board members, the company, and company management. And by the way, the AFL–CIO put a rulemaking petition into the SEC in December asking for this, and although we haven't been waiting as long as the Council has been waiting, we are still waiting to hear back from them.

Then this Committee should encourage the NASD and the New York Stock Exchange, who have the authority to do this, to require that this higher standard of independence be the relevant standard for measuring the independence of members of audit and compensation committees.

With genuine independence from management must come genuine accountability to shareholders. Shareholders should have access to management's proxy, not just for shareholder proposals on the very narrow range of subjects that are currently allowed, but for director candidates that a substantial number of shareholders want to see on the board of the company they invest in. Investors also deserve the right to bring before the annual meeting through management's proxy, which is generally the only economically viable way of doing so, any proposal that is legal and can be shown to enjoy significant shareholder support. Shareholders themselves should be the determinants of what is ordinary business and what merits a discussion with the management they hire.

The second area in need of reform is the practice of public accounting. There are three issues here. And I will treat them in a little detail. I do not mean by doing so to suggest that they are necessarily the most important issues. I think, as Sarah was alluding to, there are many very important components here.

The three issues, though, in the accounting area are: Independence, oversight, and the process by which the rules are made. In regard to independence, the simple fact is that you cannot be a public auditor with an obligation to get the numbers right for a public audience and also be a consultant whose aim is to advise executives on how to optimize the numbers. The tension between those goals is too severe and the rewards for compromising the audit responsibility are too great. It is just too easy for an auditor to blend those rules and end up like Arthur Andersen at Enron,

structuring SPE's—Special Purpose Entities—as a consultant and auditing those same structures as an auditor.

The Big 5 firms now seem to be arguing that if they cannot earn the big money as consultants that they won't be able to attract top people. I believe that argument was made before this Committee recently. From an investor perspective, we would say that the opposite is true—that unless audit and consulting functions are separated, the Big 5 will not be able to attract anyone with any integrity to their audit practices, and integrity is what worker funds want in the auditors their firms hire.

The next issue after independence is oversight. Former SEC Chairman Arthur Levitt has outlined what we believe are the key characteristics of a much needed public auditor oversight body—members independent of the accounting industry, full investigative and disciplinary powers, and independent funding, optimally through the small fees assessed on public companies as the current SEC is partially funded.

Finally, there is the rulemaking process. Anyone familiar with the political pressures brought to bear on FASB around accounting for executive stock options in the mid-1990's, not to mention the decade long paralysis on special purpose entity accounting knows that FASB is too open to pressures from issuers and those beholden to issuers currently to adequately address the needs of investors and the public. Here there are a variety of options available for dealing with that. I think we are open to looking at any number of them. But there really must be change in the way that FASB is governed and makes decisions.

Then there are the Wall Street analysts. The witness who preceded me I think did a really impressive job at outlining the issues there and what some of the solutions should be. I will say from the perspective of the consumers of the analysts, that they play a vital role because they interpret the numbers. Most work with their 401(k) plans, most anybody, even those with the expertise, do not have the time to do the analysis that analysts.

But, tragically, analysts in recent years have become captive to the investment banking side of their firms—Wall Street analysts, that is, and I recognize that they are not all analysts by any means. That is why part of a comprehensive package of reforms would be a provision banning basing analysts' compensation, not just banning it basing it on specific transactions, as Harvey Pitt and the NASD would have it, but barring any analyst tie, any compensation for analysts that is tied to investment banking performance specifically in general.

Finally, I want to address the ultimate accountability measures available to shareholders—recourse to the courts. The AFL–CIO and worker funds view litigation as part of a continuum of tactics for holding the management of the companies we invest in accountable, and for obviously recovering money fraudulently taken from worker retirement funds. As such, we strongly believe that the current immunity from civil suits in the law for those who aid and abet securities fraud is outrageous—and directly connected to the rise in accounting restatements and in accounting fraud since the Supreme Court's wrongly decided the Central Bank of Denver case in 1994.

In addition to a legislative fix, the Central Bank of Denver, we support a number of other reforms in the area of securities litigation relating to the partial repeal of the Private Securities Litigation Reform Act. Specifically, the restoration of joint and several liability in private securities cases, so that we do not have what we are seeing now in the Enron case, where everyone is chasing a few dollars, and the extension of the statute of limitations in securities cases beyond its current 3 years.

There are hundreds of millions of dollars in losses in Enron that cannot be pursued in the courts by worker funds, particularly by public employee funds, because of the current short statute of limitations.

Finally, I want to add that the AFL–CIO strongly supports increases in the SEC budget and full funding for pay parity. It is really an astounding fact that the monies realized by Enron's insiders in the last year before Enron went bankrupt are several times the size of the SEC's entire budget. And that should tell us something about where we have landed and where we need to go.

Together, these measures constitute a comprehensive approach to the problems presented by Enron and similar companies. This approach is in great measure embodied in the House bills introduced by Representatives LaFalce and Dingell. Here in the Senate, Senator Leahy and Majority Leader Daschle have introduced a very positive bill on litigation issues. Senators Corzine's and Dodd's bill on accounting issues and Senator Nelson's bill on board conflicts also, each in their areas, are quite positive steps. But there is a desperate need, we believe, for a comprehensive approach here in the Senate, one which we are confident this Committee can and will provide.

In closing, I wish to strongly emphasize the labor movement does not view what happened at Enron as simply the product of a few bad people. While those individuals who have been given the responsibility to manage workers' and the public's money need to be held to a single high standard, we believe at the heart of what happened at Enron are systemic problems that need systemic solutions. These solutions will offend powerful interests and they will fight them as hard as they can, but they will protect America's working families, and that is what we need today.

The AFL–CIO welcomes the opportunity to continue to work with the Banking Committee as you take up this very important and profound challenge.

Thank you very much, Senator.

Chairman SARBANES. Thank you very much, Mr. Silvers.

Let me ask you very quickly a couple of very specific questions. You talk about independence and oversight. What do you mean by independence?

Mr. SILVERS. With respect to the auditing profession, I am really talking about here the conflict of interest—there are several layers here. First, you have the conflict of interest that occurs when the auditor is also a consultant. That situation puts——

Chairman SARBANES. I am talking about whatever oversight board you have. When you say the members of that board should be independent, what do you mean by independent?

Mr. SILVERS. There is a history in this area of self-regulation by the industry.

Chairman SARBANES. Right.

Mr. SILVERS. We do not believe that practitioners in the public accounting field should have a significant role in the governance of the oversight board. Now it may make sense to have a member or two. But the majority of any public oversight board needs to be representatives of the investing public, not of the accounting industry.

Chairman SARBANES. Does that mean that they should not be accountants?

Mr. SILVERS. I think that there is a difference between accountants in general and practitioners, people involved in the auditing of public firms.

However, I would still say that I believe the majority of this board should not be accountants. I think that it may be appropriate that more of them be accountants who are not involved in the auditing of public companies. But I believe that it is important that this board not be in any sense a self-regulatory body of the kind that we have seen in that industry.

Chairman SARBANES. We have had some people at the witness table who are accountants. In fact, they have been partners in some of the major accounting firms.

Mr. SILVERS. Right.

Chairman SARBANES. They are not there now. They have done other things.

Mr. SILVERS. Right.

Chairman SARBANES. And some of the strongest testimony we have gotten for better oversight has come from those very people.

Mr. SILVERS. Sure.

Chairman SARBANES. Should they be eligible to be on this board or do they contradict your desire for independence?

Mr. SILVERS. No, I believe that they should be eligible to be on the board. What I was saying, Senator, about this, is that the majority of this board should be representatives of investors and the public. But I believe it is quite important, in fact, to have some individuals of the kind that you are referring to making up part of the board.

Chairman SARBANES. Does anyone else have any thoughts on that particular subject?

Ms. TESLIK. If I could add to that. I think that most investors care particularly about who appoints these people, not what their credentials are, because, obviously, if they do not know what they are talking about, they are not going to be any good. But an accountant who we appoint is different than an accountant that the AICPA appoints. So, I think you need to focus on where they come from because that is who they will report to.

Chairman SARBANES. Mr. Silvers, I wanted to ask you, what do you think the statute of limitations in securities cases ought to be?

Mr. SILVERS. Senator, there have been different suggestions in this area. My feeling is that it ought to be something in the range of 5 to 7 years for recoveries. This is not the time to bring the claim, but how far can you look back to price the recovery?

I also believe that there ought to be some latitude given to judges in this area because there are circumstances in which you have a continuing fraud that an iron-clad cut-off may not properly address.

Chairman SARBANES. Now, Mr. Bowman, you had, I thought, an impressive listing of what firms ought to do, so we had greater assurance about analyst independence. But how do we make sure that firms do that?

This is kind of an appeal to the firm to do right. But what structure or framework do we have within which the firm operates that will place pressure upon them to do right?

Mr. BOWMAN. Senator, we have seen over the years that market forces and competitive forces are very powerful. For example, about 12 years, AIMR introduced performance presentation standards to make uniform the way that investors and managers presented their returns on their portfolios because up until that time, there was a lot of abuse going on with regard to how performance numbers were reported. And when AIMR first came up with these standards, they were met with a great deal of resistance and it took several years, basically, for them to begin being accepted.

However, once one major firm began accepting these standards and using these standards and disclosed that they were in conformance with AIMR presentation standards, it was amazing how quickly other investment management firms fell into line and now it has become an integral part of the RFP process when people look for managers, whether they are in compliance with the performance presentation standards or not.

So, I would hope that if Wall Street firms that have these conflicts, if they were to adopt the recommendations that we have put forward, disclose them prominently and continue to disclose them to clients and the investing public, my suspicion is that competitive forces would cause most of the other, if not all of the others, to adopt them as well.

Chairman SARBANES. Why shouldn't they be required to do it?

Mr. BOWMAN. I think they probably should be. We are an organization of individual investment professionals. We are not an organization of institutions. But, certainly, we are all for anything that would restore investor confidence in the markets and in security analysts because, like I say, a very small percentage of our membership are analysts that have these conflicts. But it is tainting the entire profession.

It has also, as my fellow panelists have indicated, damaged individual investors and their confidence in the markets. And anything that could be done to restore the confidence, I am sure that AIMR would strongly support.

Chairman SARBANES. Any observations on this issue?

Mr. SILVERS. Senator, there has been, I think, a back and forth about this that you rightly point out about whether this can be dealt with voluntarily or not. The problem fundamentally comes down to one word, and that word is transactions.

It is in the Security Industry Association, which is the Wall Street folks that we have been focusing on here, their voluntary guidelines say that you cannot tie analyst compensation to a single investment banking transaction. But you are still free to tie it to

the overall performance of investment banking. That distinction that they draw guts their voluntary code.

The AFL–CIO, we have been involved in this issue more than a year now and testified on the House side last summer. We were profoundly disappointed to see that when the NASD, with the blessing of Chairman Pitt, came forward with their ideas on analyst independence, they left that word transactions in there. And until somebody, whether it is the Commission or the Congress, mandates that you cannot tie analyst compensation to investment banking performance, the problems that we have in this area are going to continue.

Chairman SARBANES. I would like to address the audit committees for a minute.

We had former Chairman of the SEC, Rod Hills, testify in the lead-off hearing that we had. He said:

> The audit committees of too many boards are not exercising the authority given them or the responsibility expected of them.
>
> Audit committees should be protecting their auditors. But board members are too often chosen by the CEO, who also decides who will sit on the audit committee and who will chair it.
>
> The members seldom ask the auditor if there is a fair or better way to present the financial position of the company. They seldom play any significant role in choosing the audit firm or in choosing the new partner from the audit firm. And they seldom establish themselves, in short, as the party in charge of the audit and they do not establish themselves as the party in charge of retaining the auditor.

Now how important is the role of the audit committee and what can we do, if it is important, to strengthen or enhance it?

Senator METZENBAUM. I would just say that we think the audit committee is particularly important. But we are concerned about the independence of the audit committee. Too often, the audit committee is too intertwined with management and, as you say, chosen by management. As a consequence, you get this kind of fealty to the management that an audit committee shouldn't have. An audit committee ought to have almost a wall of independence between it and the corporate leadership.

The way it is at the moment, that is not the reality. And perhaps some procedure can be developed where audit committees are selected not just by the corporate executives, but by turning to some outside sources for recommendations as to who can serve on the audit committee.

Ms. TESLIK. If I can add to that?

Chairman SARBANES. Ms. Teslik.

Ms. TESLIK. I alluded in my testimony that I did not read to you that the perhaps single first step you should take to increase auditor independence is to require a listing standard that the audit committee of the board hire and fire the auditors.

After all, it is usually managers rather than auditors who start the frauds, and while audit committees may not be as independent as we would like, they are a lot more independent than the managers whose books are being reviewed. And that is a relatively easy, relatively costless step to have a listing standard saying the audit committee hires the auditors. They report to the auditors.

It is probably a little bit more complicated to say that at least once a year, the audit committee has to meet with the auditors without management present. But that matters because so often,

boards have independent committees. At every single meeting of that committee, management sits in unofficially.

I think that is a relatively low-cost, relatively easy, and relatively legal simple fix. The audit committee hires, the audit committee fires. It is in a listing standard.

In addition, as silly as it sounds, the suggestions you have heard elsewhere that the audit committee, as well as the CEO, sign the financials, makes a difference. When you sign your tax returns, you probably think a little bit. Again, it is very cheap. It takes 2 minutes. But signing the document gives you a completely different feel than not signing the document. That can also be done in a listing standard.

So, you have two ways, relatively inexpensive, relatively simple, with a clear legal route to funnel this, that would help get the audit committee involved.

I suspect Enron's directors would not have liked to be in the position they are in now. And if Arthur Andersen had come to them and said, fraud is occurring on your watch, however much they were appointed by management, I suspect they would have said, I do not want this to happen.

You at least increase the change that some boards will do something with two easy, relatively inexpensive legal changes.

Chairman SARBANES. As you note, the exchanges could require that as part of the listing standards. Is that correct?

Ms. TESLIK. It could. But they won't unless you make them.

Chairman SARBANES. That is where I am going now.

[Laughter.]

They have not done it. Presumably, the SEC could require it. Is that right, under current authorities?

Ms. TESLIK. It could. There is some debate over the SEC's ability to oversee the New York Stock Exchange. This is a most bizarre debate.

Whenever we contact the SEC about something the New York Stock Exchange has failed to do, the SEC's response is, we cannot help it. I say, well, do they regulate you or do you regulate them? And they say, because of the lawsuit over one share/one vote, the Business Roundtable lawsuit, it is not clear to them how well they can oversee the New York Stock Exchange.

I think it is clear. I think they can do it. You certainly can do it. The New York Stock Exchange won't do it on its own. It is paid by corporate executives to list their companies on the exchange.

It will not regulate those executives for our benefit. You can certainly mandate it. I think the SEC can. You could further this by making clear in your legislation that the impediment raised by the Business Roundtable lawsuit is not there.

Mr. SILVERS. Senator.

Chairman SARBANES. Yes.

Mr. SILVERS. Sarah's first suggestion, that the audit committee do the hiring and monitoring directly of the auditors, is in a rulemaking petition that the AFL–CIO submitted to the SEC in December, which, again, we have not heard back from them on.

Chairman SARBANES. Chairman Breeden, when he was before us, raised strong concerns about the practice of corporations making large loans to their executives. First of all, do you share that con-

cern? Presumably, you do. But what do you think should be done about it? The amounts are staggering.

Ms. TESLIK. The amounts are staggering.

Chairman SARBANES. In some of these instances, on February 16, the *Houston Chronicle* reported that last year, Ken Lay borrowed about $70 million from a line of credit provided by Enron Corporation and repaid it with stock, a $15 million loan at Global Crossing.

On March 13, *The New York Times* reported that the SEC is looking into hundreds of millions of dollars of loans WorldCom made and arranged for its Chief Executive, Bernard J. Ebbers.

So what is your view on this issue?

Ms. TESLIK. It is always significant Sherlock Holmes taught you, that when there are facts that do not make sense, there are other facts you need to know. When CEO's, the wealthiest people in the United States, get loans, not from banks, get loans at all, but get loans from companies, you have to ask yourself, what is going on?

There are a couple of things that are going on that are of concern to you. One is that loans are used to cover CEOs' dumping stock before a company crashes. This is what happened in Enron. This has happened other places.

Because our disclosure regulations are written in such a way that a CEO can combine the fact that he/she has a loan, the fact that he/she has stock options, to use the stock to repay the loan. And what it does is it dumps the stock. It gives the CEO cash, but our regulations allow disclosure of that transaction to be delayed sometimes for more than a year.

So, we average investors, who watch carefully when CEO's dump stock, do not know for more than a year that the CEO has dumped the stock. And that is, I think, the first place that you should focus and that is an easy place to focus.

Chairman SARBANES. By dumping it back to the company in repayment of his loan.

Ms. TESLIK. In repayment of the loan. So, they walk away with the cash.

Chairman SARBANES. You would make them report that immediately, I take it.

Ms. TESLIK. Report that immediately.

Chairman SARBANES. Or 24 hours, or whatever it is.

Ms. TESLIK. Right. It is very tricky to get involved with whether companies can lend money to their employees. That is messy. It is not messy to require instant disclosure to cover these loans, as well as stock sales, because it is merely a way to cover up stock sales.

Senator METZENBAUM. Mr. Chairman.

Chairman SARBANES. Yes.

Senator METZENBAUM. I do not see any corporate purpose in the corporation lending money to its executives. And I think that it very properly, appropriately, might call for legislation to bar the practice.

I do not see any reason why the chief executive of a company, or some lower-level figure, should be able to borrow hundreds of thousands or millions of dollars from his or her corporation. I cannot see any normal business purpose that would be gained for the corporation. And I think it is totally inappropriate—more than inappropriate. I think it should be illegal.

Mr. SILVERS. Senator.

Chairman SARBANES. Yes.

Mr. SILVERS. One point about this. I think Sarah's explanation points out a larger issue here that the loans are one piece of, which is that, in the current complex financial markets, it is possible for CEO's to do all kinds of things that are not currently forced to be disclosed.

Loans are one. Hedging their stock is another. There are all sorts of ways in which you can get hidden compensation and change the nature of the compensation, so that what appears on the surface to be a compensation measure that aligns CEO interest with shareholders, even if it is excessive and indefensible in its size, may turn out, if you understand all the loans or options or other hedging contracts, derivatives contracts associated with it, to not even provide the incentive effect.

For example, if you buy the stock with a loan, it looks a lot more like an option than stock, which is less favorable from a shareholder perspective for an executive to hold. If you take a stock and hedge it, you can turn it into essentially a Treasury bill, which has no shareholder alignment whatsoever.

Our disclosure regulations are just simply not up to where the markets are right now and what they allow CEO's to do.

Chairman SARBANES. Mr. Bowman talked about a lot of issues which could involve disclosure. But how much of it can disclosure do as opposed to actually mandating standards and prohibit certain conduct?

Mr. SILVERS. I think that disclosure only works when people have the power to act on it, and act on it effectively. The increased disclosure needs to be tied up with some of the measures that we have talked about today, such as giving shareholders wider access to the proxy, facilitating the economics of running independent directors for boards, ensuring that the compensation committee, for example, is really independent directors and not people in the pocket of the CEO in some fashion.

Those measures start moving to the point where shareholders and other investors have the ability to act on the disclosure.

I think if you look at the history of executive pay in the 1990's, you will see that, although there has been some incremental improvements in disclosure, the ability of shareholders to really monitor that pay and the willingness of boards to do their job in that area, has not really improved that much.

Maybe Sarah will add to that. I do not know.

Senator METZENBAUM. Simply stated, I do not believe disclosure adds very much. You learn that the chief officer, principal officer, borrowed $2 million. I am a stockholder. What can I do about it? I cannot say that there is anything wrong about it. And yet, he may not be able to repay it. The fact is there may be no business reason to be doing it.

So, I do not think disclosure solves the problem at all. I think there just ought to be a firm bar against it, and the shareholders would be much better represented if that were the case.

Ms. TESLIK. I have to say I would follow Damon on this one. The loans are a good example. Corporate loans to CEO's originated from corporate moving fees, when they would move an executive

from one place to another, which I think is a perfectly legitimate thing for a company to do. And it gets very messy when you in Congress say, you cannot ever lend money to an employee.

As much as I agree with the Senator that these CEO loans tend to stink, I think it is probably a better solution to let shareholders take care of the problem. They are employees, after all, and do as Damon said, which is you give us a disclosure and then take off a couple of the handcuffs that prevent us from acting, and we will take care of the rest.

If there was any real threat that when a company gave $340 million in loans to its CEO, that the board might not get reelected, that loan wouldn't be made. And I think it is probably a more appropriate solution for our private sector. You give us the disclosure, and then just remove a couple of the things that prevent us from acting, and let's see how that works.

Chairman SARBANES. What are some of the things?

Ms. TESLIK. As Damon said, give us some ability, you can tinker with the rules, but give us some ability to select directors.

For example, if 25 percent of the shareholders say to the company, we would like you to run someone, that that person gets put on the ballot. He doesn't get elected. He just gets put on the ballot. That alone would make a huge difference.

Chairman SARBANES. And the others?

Ms. TESLIK. Is that if a shareholder proposal is backed by a large percentage of shareholders and passes, it needs to be implemented, because right now, we cannot submit a shareholder proposal on a loan. That would be considered ordinary business unless there are certain circumstances. But if 85 percent of the shareholders at WorldCom said that we do not want you to lend the CEO money, then they could not lend the CEO money. Right now, they still can.

Those two things, with disclosure, I think you would see a lot of change.

Chairman SARBANES. Mr. Bowman, do you want to add anything?

Mr. BOWMAN. Yes. I find it very troubling, and I agree with my panelists here, why a chief executive officer or other high-paid individual within a firm would need to borrow money from his or her own firm, especially in the amounts that we are talking about. That doesn't seem to pass the smell test to me at all. And as far as the inadequacy of disclosing it, I do not think that it ought to be occurring anyway.

Where I was going with disclosure is that there are many other ways that executives are paid, for example, stock options, and there are other ways that firms can avoid putting what we consider to be the expenses on the income statement and shown on the balance sheet, that really does mislead investors.

We believe that requiring disclosure of those kinds of things is very helpful, not necessarily a solution in many cases, but very helpful because to disclose generally drives behavior. And if management knows that they are going to need to disclose the stock options that were given or disclose how they deal with special purpose entities or disclose whatever, their actions could be affected in ways that are more positive for investors.

But certainly, disclosure—I agree with Senator Metzenbaum—it is not necessarily the solution.

Chairman SARBANES. Do you think the stock options ought to be reflected on the balance sheet as an employee expense?

Mr. BOWMAN. Absolutely. We have been advocating that for probably 10 years. And we are on record as having pleaded with the SEC and the FASB to have options shown as an income statement expense. Yet, corporate influence and other outside influences have outweighed our recommendations. But we certainly are strongly in favor of showing those kinds of things as expenses on the income statement.

Chairman SARBANES. They are out there beating the drum now that it will mean the demise of an important economic sector. It is interesting to watch. Did you want to add to that?

Mr. SILVERS. I just have an anecdote for you, Senator.

The AFL–CIO at one time brought a shareholder proposal to a major insurance company with a significant financial services business, and asked that they change their stock options so that the CEO would not be compensated based on the generic rise of the market, but would only be compensated if his company outperformed his sector.

In the meeting we had with them, they said to us, we would like to do that, but we do not know how to really price these options. We do not know what they are worth. We wouldn't know how to do what you are asking us to do.

This is a company which I know for a fact had a trading floor full of hundreds of people who did nothing all day long but price options. And I think that, frankly, they try to pull that same nonsense here too often.

Chairman SARBANES. I think, Howard, you think the SEC should do it directly and not have a board over the accounting people. Is that correct?

Senator METZENBAUM. That is correct.

Chairman SARBANES. What do the others think about that?

Mr. BOWMAN. Senator, I believe that the SEC, if given proper funding and resources, and given the independence that it really needs, could do an effective job of overseeing the FASB and the accounting. I do not know enough about the proposals to create an independent oversight, but I do know that the SEC has been hampered by the fact that they haven't had proper resources.

Chairman SARBANES. Some have argued that if we can structure the board well enough, it might actually have more independence from political influence than the SEC would have. That is an interesting question. Do people have a view on that?

Ms. TESLIK. I personally, I suppose, am a little bit cynical, having done this job almost 20 years, about the long-term independence of any private-sector company with Government authority. Obviously, I have had to work with FASB and we have had to work with the stock exchanges. And my experience is that these entities tend to have the worst of both worlds rather than the best.

They are not accountable to anyone. We do not elect them. They do not disclose anything. Do you know what Dick Grasso makes? We know what you make. We do not know what CEO's make. They tend to be funded by parties they are supposed to regulate. Even

if it doesn't start out that way in the beginning, it becomes that way. And our ability to either police them, oversee them, or even give them input, tends to be less than the Government entities that we deal with.

I am not always happy with the SEC. They have been sitting on a lot of things that could have helped Enron. By and large, we get better responses, more quickly in the sunshine, with better regulation from Government bodies.

I do agree with you, if a private-sector entity is set up in the accounting area, who appoints the people matters most.

Chairman SARBANES. Is it important that they have a guaranteed mandatory source of funding, or does that carry the risk that it will make them so removed and so independent, that no one can talk to them, so to speak? Do you have a view on that?

Ms. TESLIK. I think the mandatory funding matters. You do have the accountability problem. Who can speed up FASB?

On the one hand, FASB is too dependent on other entities that give it money, and so that influences it——

Chairman SARBANES. They go around with a tin cup begging for money.

Ms. TESLIK. Yes, they do. And that is not a good thing. But let's suppose that we now mandate the money and FASB has the money. We still have the problem that it is too slow, which is one of my problems with private-sector companies with Government authority.

How do you speed up FASB? Obviously, with specific issues, the SEC can say, get the darn SPE rule out by the end of the year, and they have done that. But that is something you have to deal with when you have a private-sector entity with governmental authority. I think, by and large, mandated funding is better than the influence that the absence of funding creates. But then you have an accountability problem.

Chairman SARBANES. Of course, FASB is subjected to all kinds of pressures. I have seen it at work. There is no question about it.

Ms. TESLIK. Yes, more than we have.

Chairman SARBANES. So that part of their slow-up is that it may not be internal to FASB, but may be external in terms of the pressures that are being directed at them.

Mr. SILVERS. Senator, there is no question that on a number of the issues we are discussing here today, FASB in particular has been hamstrung by outside pressures. And the question is——

Chairman SARBANES. The Public Oversight Board, Bowsher was just here on Tuesday. They were going to do these special exams and the companies told them, we are not going to give you any money. Your budget's gone if you go and do that. Well, that is a pretty powerful weapon to bring you to a halt.

Mr. SILVERS. Sir, I think the problem here is trying to figure out how to balance this out because, for example, the SEC is subject to similar pressures.

Chairman SARBANES. Right.

Mr. SILVERS. As we saw during Arthur Levitt's efforts on behalf of auditor independence.

One thing we believe would be important here is to look at the extent to which in dealing with the SRO's and with FASB, the Commission itself feels handcuffed to move them along sufficiently.

I think our view would be, although we are open to discuss it, to think about it, because it is not a simple problem, that, in general, a stable, secured source of financing that doesn't give the ultimate source of the funds much power—I assume we are talking about private-sector sources now. I wouldn't want to suggest that that would be true of this body—is probably the best way to go.

Senator METZENBAUM. Mr. Chairman, I think one of the things that we, the Consumer Federation of America, are concerned about is that Congress will look at this problem and has really had any number of committees—I think I was told that there are three committees conducting hearings on this subject today.

What concerns us is that after all the hearings, there will be a lot of noise and a lot of hearings, but there won't be any effective legislation, tough legislation to correct some of the problems.

I think that the accounting industry is gearing up for a public relations program. And I would just say the sooner the better. Tougher will serve the American economy that much better and will serve the American people that much better.

I hope that you, as the Chairman of the Banking Committee, will see that there is some movement in this area before all the excitement dies down and people say, well, they made the indictments, they did this and that. We can go back to the way it has been and the world won't come to an end.

Chairman SARBANES. Well, I am sure that we can count on the Consumer Federation and the others that are at the table to keep our eye focused on the important objectives here.

Mr. BOWMAN. Senator Sarbanes.

Chairman SARBANES. Go ahead.

Mr. BOWMAN. I just wanted to comment with regard to the oversight bodies, the SEC and the FASB.

We agree that there ought to be mandatory funding there. But in addition to that, I think, one of the major problems has been, is the lack, the dearth of investor input and influence at the FASB.

I have witnessed over the years that FASB is very, very highly influenced by corporate interests, by issuers of financial statements rather than users of financial statements, such as investors and money managers. And I think that real improvement could be made if there was more a mandate for more investor interest personnel at the FASB and the SEC, rather than accountants and corporate interests.

Chairman SARBANES. Well, if the funding source is guaranteed as a levy, automatically, and if the appointments to the board are made by appropriate public interest people, the combination of those two things might provide a dynamic that brings a very important change in the operation of a particular body.

I do not know. That is one of the things we are trying to puzzle through right now. But it seems to me that offers some opportunity if you go down that path, to get a better system and structure into place.

I think it is clear that the existing structure and system has not worked and the challenge, really, is determining what changes can

we bring about in it that will significantly diminish the likelihood of any of these things occurring again.

I do not know that you can guarantee that they won't because, as Ms. Teslik kept pointing out, humans are humans as you move through. But you have to get a structure that tries to limit and restrain and control that as best we can.

That is one of the challenges we face and it is one of the reasons we have tried to do a very careful and comprehensive set of hearings, so we establish an appropriate basis on which then to act.

This panel has been enormously helpful. Is there anything that anyone wants to add before we adjourn?

Mr. SILVERS. Senator, if I could just make one comment about something you asked about earlier, which is the distinction about disclosure and substantive regulation.

Chairman SARBANES. Yes.

Mr. SILVERS. I would hope that, as you move forward on the task of crafting legislation here, that you consider that, traditionally, the securities laws have had a disclosure-only sort of perspective. And the pension laws have had a more substantive regulation to them. ERISA tends to look more at barring things and that kind of thing.

However, in recent years, the securities laws I think have become more relevant to the set of retirement issues and retirement securities issues that ERISA historically dealt with. And there are areas in which the determined bright-line rules and bars on certain kinds of conduct that, say, the prohibited transactions rule in ERISA has, make more sense in the securities area.

One example of that is with the conflicts involving analysts and investment banking practices. I think another example has to do with the auditors and the conflicts there, that there simply is not an ability in the system to have mere disclosure regulate effectively the conflicts at work in those areas.

I think it is worth noting that and knowing what is involved there and thinking about in those areas in which disclosure works and those areas where it really won't because there is not the power to act on it.

Chairman SARBANES. That prompts me to ask a question before I let the panel go.

We are getting this argument now that if you—I am a small business. I have a small accountant. And we interrelate here and we work together. If you separate these things out or put these additional requirements, it is going to become an onerous burden on me to carry out my activities.

Now, first of all, it would seem to me that we would draw a sharp line between public companies and nonpublic companies. I think most of our discussion has focused and should focus on public companies.

Once you list on an exchange, it seems to me that you are moving into a different arena. Then there are obligations that go with that because you have a very different investor protection issue.

Do you all agree with that, that we are essentially focusing in the arena of the public companies?

Mr. SILVERS. Absolutely.

Senator METZENBAUM. Yes.

Ms. TESLIK. Yes.

Chairman SARBANES. What do you say to the argument where they say, well, if you establish these requirements in that arena, State accounting boards will simply adopt them and apply them to everybody, and then we won't be able to do the sort of business that doesn't raise any of these problems and it needs to be done. What is your response to that?

Ms. TESLIK. The State accounting boards are not known for their activism.

[Laughter.]

I don't think that is a fear you have to lose a lot of sleep over.

Mr. BOWMAN. I think that is a spurious argument.

Mr. SILVERS. You know, Senator, when the securities laws were adopted, States had securities regulation. States have corporate law. By that argument, one might have feared that the entire body of securities regulation would have been imposed on every restaurant and taco stand and newsstand in the country. States are more sensible than that.

Chairman SARBANES. Okay. Thank you all very much. This has been an extremely helpful panel.

Senator METZENBAUM. Thank you, Mr. Chairman.

Mr. SILVERS. Thank you.

Mr. BOWMAN. Thank you.

Ms. TESLIK. Thank you, Mr. Chairman.

Chairman SARBANES. The hearing stands adjourned.

[Whereupon, at 11:59 a.m., the hearing was adjourned.]

[Prepared statements and response to written questions follow:]

PREPARED STATEMENT OF SENATOR HOWARD M. METZENBAUM (RET.)

CHAIRMAN, CONSUMER FEDERATION OF AMERICA

MARCH 20, 2002

Good morning, Mr. Chairman, Senator Gramm, and Members of the Committee. My name is Howard M. Metzenbaum and I now serve as Chairman of the Consumer Federation of America (CFA). CFA is a nonprofit association of some 300 pro-consumer organizations, with a combined membership of over 50 million Americans. I appreciate your invitation to offer my comments on this very important issue. I am especially pleased to appear before my old friend and colleague, Chairman Sarbanes.

I spent my career in the U.S. Senate working to prevent corporations from running roughshod over the rights of consumers and workers. I have to tell you that I have never seen a more appalling example of heartless, unfettered corporate greed than in the Enron debacle. This company lied to their investors, lied to their employees, hid crucial information about their finances and tried to improperly influence Government officials. And in criminally indicting Enron's auditing firm, Arthur Andersen, the Department of Justice has said that it believes that Andersen was a party to this massive deception.

How could this energy giant have gone from number seven on the Fortune 500 to bankruptcy court almost overnight? The answer, of course, is that it did not. The problems that ultimately brought Enron down were a long time in the making. They were simply hidden from investors' eyes. That revelation has prompted an even more pressing question, since it has broader implications for investors in all publicly-traded companies: Given all the safeguards in our system designed to ensure investors receive full and fair disclosure, how could Enron have succeeded for so long in presenting a false picture of financial health? The disturbing answer is that, in this case as in others, all the safeguards designed to protect investors failed, and failed miserably.

- The rules that dictate what information companies have to disclose and how they have to disclose it failed to produce an accurate picture of Enron's finances, even where the company complied with the rules.
- The corporate board that is supposed to supervise management failed to ask the tough questions, challenge questionable practices, or require more transparent disclosure.
- The auditors, whose job it is to certify that financial disclosures are not only prepared according to the rules but also present an accurate picture of company finances, signed off on financial statements that clearly failed that test.
- The Securities and Exchange Commission, which also has the responsibility for reviewing corporate disclosures, had not reviewed the energy giants complex financial statements since 1997.
- The credit ratings agencies and securities analysts—outside experts that investors rely on to analyze all of the available information and provide an independent assessment of the company's credit- or invest-worthiness—did not provide any advance warning of possible trouble.

In short, the real story out of the Enron disaster, at least for policymakers, is not that its corporate managers went to great lengths to hide the company's indebtedness and artificially inflate its earnings. Our system was designed with just that behavior in mind. The real story is that all the safeguards that we rely on to keep corporate executives honest failed. Clearly, key parts of the system are broken, and it is Congress's job to fix them. Only a comprehensive package of strong reforms will do the job.

Restore Value and Integrity to the Independent Audit

The most important thing Congress can do is restore value to the independent audit. To accomplish this, it must enhance auditor independence, provide effective regulatory oversight of accountants, and restore the threat of private litigation as a strong deterrent to wrongdoing.

MAKE THE "INDEPENDENT" AUDIT TRULY INDEPENDENT

The Independent Audit Has Never Been More Important

The whole point of requiring public companies to obtain an independent audit is to ensure that outside experts have reviewed the company books and determined that they not only comply with the letter of accounting rules but also present a fair and accurate picture of the company's finances. Auditors have profited handsomely over the years from performing this important public watchdog function. Unless the

auditor is free of bias, brings an appropriate level of professional skepticism to the task, and feels free to challenge management decisions, however, the audit has no more value than if the company were allowed to certify its own books.

The independent audit is arguably more important today than it has been at any time since the requirement was first imposed in the 1930's. More than half of all American households today invest in public companies, either directly or through mutual funds. They do so primarily to save for retirement. As a result, their financial well-being later in life is dependent on the integrity of our financial markets.

At the same time, corporations today are under great pressure to keep their stock prices on a smooth upward trajectory. As one writer has noted:

> No longer is a higher stock price simply desirable, it is often essential, because stocks have become a vital way for companies to run their businesses. The growing use of stock to make acquisitions and to guarantee the debt of off-the-books partnerships means, as with Enron, that the entire partnership edifice can come crashing down with the fall of the underlying stock that props up the system. And the growing use of the stock market as a place for companies to raise capital means a high stock price can be the difference between failure and success.[1]

Corporate managers have a strong incentive to manage their earnings in order to present the picture of steadily rising profitability that Wall Street rewards. And, as the Enron case clearly illustrates, murky accounting rules that rely on numerous subjective judgments make it easier than it should be to construct a false picture of financial health. The Enron case also makes it abundantly clear that an auditor whose independence is compromised may be all too willing to sign off on financial statements that conceal, rather than reveal, the company's true financial state.

Finally, Enron's dramatic collapse, and Arthur Andersen's obvious complicity, have shaken public confidence in the reliability of companies' financial statements. That adds an unhealthy element of uncertainty to financial markets. As the SEC noted when it proposed its auditor independence rules in 2000: "Investors are more likely to invest, and pricing is more likely to be efficient, the greater the assurance that the financial information disclosed by issuers is reliable. Independent auditors play a key role in providing that assurance."

Many Factors Undermine Auditor Independence

Because of the central importance of the outside audit in upholding the integrity of our system of financial disclosure, the Supreme Court has stated that this "public watchdog function demands that the accountant maintain total independence from the client at all times." Unfortunately, accountants have shown virtually no real willingness to accept the responsibility for maintaining their independence that goes with the privilege of performing audits.

Since the mid-1990's, most of the big firms have dramatically increased their sales of consulting and other nonaudit services to their audit clients, despite the clear conflict of interest that this creates. Today, virtually all big companies receive both audit and nonaudit services from their accountants, and they typically pay between two and three times as much for the nonaudit services as they do for the audit itself. In some cases, the disparity between audit and nonaudit fees is far greater. Furthermore, consulting services increasingly drive the profitability of accounting firms. If an auditor's tough questioning of management were to threaten its more profitable consulting arrangement, that auditor might expect to face tough questioning of his own from higher ups at the firm.

Other factors also undermine auditor independence. The lack of independence starts with the fact that auditors are hired, paid, and fired by the audit client. This basic conflict is exacerbated by the general lack of client turnover. Auditors may reasonably expect to keep the same client for 20, 30, even 50 years. These long relationships make it that much harder for the auditor to challenge management aggressively, not only because of the friendships that are likely to develop between auditors and company management, but also because they risk losing this seemingly endless stream of future audit revenues if their tough questioning causes them to lose the client.

Another problem that clearly needs to be addressed is the revolving door that all too often exists between auditors and their audit clients. This was true at Enron, it was true at Waste Management, and it is a common feature in many failed audits. A constant flow of personnel from the auditor to the audit client helps to create

[1] "Deciphering the Black Box: Many Accounting Practices, Not Just Enron's, Are Hard to Penetrate," by Steve Liesman, *The Wall Street Journal*, January 23, 2002, p. C1+.

an environment in which external auditors are viewed as just another part of the corporate family. Such intimacy is not conducive to true independence.

Comprehensive Reforms Will Be Needed to Restore Auditor Independence

The only way to provide complete independence to the outside audit is to take it out of the private sector. Representative Kucinich has introduced legislation (H.R. 3795) that would create a Federal Bureau of Auditing in the SEC, and CFA has endorsed that legislation. But other less radical approaches could significantly enhance auditor independence while leaving it in the private sector. Some have suggested, for example, making the exchanges responsible for hiring accounting firms to audit the companies that trade there. The idea behind this approach is that it would minimize the company's financial leverage over the auditor, and that auditors would as a result be more likely to perceive themselves as working for investors, rather than for the audited company. This is an intriguing suggestion that we believe deserves further exploration.

Another idea that has gained some high-powered and highly credible backers is the idea of requiring periodic mandatory rotation of auditors. An audit firm that knows it has a limited term of engagement has significantly less to lose by challenging management than one that expects to retain the client indefinitely. This approach has costs as well, in the form of the learning curve at the start of an audit rotation. However, such costs can be minimized by setting a sufficiently long rotation period of 5 to 7 years. Because such an approach would significantly enhance auditor independence, we believe the benefits far outweigh the costs.

This mandatory rotation of auditors should be combined with a broad ban on provision of nonaudit services to audit clients. Certain services could be exempt, on a case-by-case basis, if it is shown that these services are closely related to the audit, directly enhance the quality of the audit, benefit investors, and create negligible conflicts of interest for the audit firm. If any such nonaudit services are permitted, they should have to be directly and separately approved by the audit committee of the board. Finally, to close the revolving door between audit firms and their audit clients, there should be a 2 to 3 year cooling off period after their involvement in the audit has ended during which members of the audit team would be prohibited from seeking or accepting employment with a former audit client.

A strong package of reforms along this line would restore real integrity and value to the independent audit. That, in turn, should go a long way toward restoring investor confidence in the reliability of corporate disclosures.

PROVIDE EFFECTIVE REGULATORY OVERSIGHT OF ACCOUNTANTS

If auditors face numerous pressures to sign off on questionable accounting practices, they face relatively little fear of sanctions if they do. Although a variety of groups including the SEC, State accountancy boards, and the AICPA all have power to discipline auditing firms and their employees for ethical and legal infractions, even serious violations typically receive little more than a hand slap.

The Current "Regulatory" System is Under-Funded, Ineffective, and Captive of the Industry

In theory, the real authority over auditors lies with the SEC. It has the power to bar individuals and firms from auditing publicly-traded companies. It also has authority to impose potentially substantial fines. In reality, however, the agency does not routinely review how auditors perform their audits, and instead delegates that responsibility to the AICPA and its Public Oversight Board. Furthermore, according to past agency officials, the SEC only has the resources to tackle the very worst cases of alleged accounting abuse, and it typically settles even those cases without an admission of wrongdoing. It took no action, for example, against a former Arthur Andersen managing partner whom the SEC said had allowed persistent misstatements on Waste Management's financial reports to go uncorrected.[2] Similarly, a PricewaterhouseCoopers' partner ordered by the SEC in 1999 to cease and desist violating securities laws did not even lose his position as lead partner on the audit in question.[3]

The AICPA sets audit standards, oversees through its affiliated Public Oversight Board a peer review system to determine compliance with those standards, and has disciplinary authority over its members for violations. According to former SEC Chief Accountant Lynn Turner, however, the audit standards adopted by AICPA are "so general that, as a practical matter, it is difficult to hold anyone accountable for

[2] Ibid.
[3] Ibid.

not following them."[4] The POB,[5] which is responsible for overseeing the industry's peer review system and other ethics investigations, is notable for having never sanctioned a major accounting firm in its 25 years of existence, even when peer reviews have uncovered serious shortcomings in a firm's audit procedures.[6] Furthermore, the POB cannot act against a firm without the AICPA's cooperation. In one case where, at the SEC's prompting, the POB did attempt to investigate possible stock-ownership violations at the major firms, the AICPA refused funding for and cooperation with the investigation, which as a result went nowhere.[7]

Even if they had the will to act, the AICPA and POB are also hampered by a severe lack of investigative authority. They cannot subpoena evidence, for example, and as a result are forced to rely on the public record in building a case. If the SEC settles a case confidentially, with neither a public ruling nor an admission of guilt, there is no public record the AICPA or POB can rely on in bringing its own enforcement actions. Where the AICPA does act, its maximum sanction is expulsion from the organization, which can have serious consequences, but does not prevent the individual from continuing to practice.

In reality, however, AICPA has shown itself to be a reluctant regulator. According to a *Washington Post* investigation, the AICPA took disciplinary action in fewer than a fifth of the cases in which the SEC imposed sanctions over the past decade. Even when AICPA determined that SEC-sanctioned accountants had committed violations, they closed the vast majority of ethics cases without disciplinary action or public disclosure.[8] The disciplinary action AICPA was most likely to take, according to the *Post* investigation, was issuing a confidential letter directing the offender to undergo additional training. Ethics committee member Dave Cotton has reported seeing "ethical lapses that resulted in millions of dollars of losses get punished with as little as *16 hours* of continuing education."[9]

A Complete Overhaul of the System is Needed

Some policymakers, including SEC Chairman Harvey Pitt and several Members of Congress, have recommended creation of an independent regulatory organization for accountants. Others have argued that the SEC should be given enhanced responsibilities in this area. Regardless of which approach is adopted, it is clear that improved oversight is needed. The following are some principles that must be incorporated in any such plan.

A. It Must Be Independent of the Accounting Industry

As one former SEC official observed to *Business Week,* "The accounting profession is very creative at taking over every group that has ever tried to rein it in."[10] For a self-regulatory organization to have any credibility, therefore, its independence must be unassailable. At a minimum, a super majority of board members must have no ties whatsoever to the accounting industry, and they must be subject to conflict of interest rules that prohibit ties to the industry for a significant period after they leave the board. Just as important, funding for the organization must be totally free from threat by industry members. The AICPA and the Big 5 firms have shown their willingness to use strong arm tactics to head off potentially embarrassing investigations in the past. They must have no such hold over any SRO that is created to provide enhanced oversight in the wake of the Enron–Andersen disaster.

Because of the tendency of self-regulatory organizations to identify with the industries they regulate, rather than the public, CFA has generally favored direct Government oversight over the SRO approach. In this case, that would take the form of direct SEC regulatory oversight of accountants. However, such an approach does not offer a perfect solution. The accounting industry has shown itself to be more than capable of influencing SEC actions, the most recent example being the industry's ability to force the agency to back off the toughest components of its proposed auditor independence rules by lining up Members of Congress to intervene.

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[4] "After Enron, New Doubts About Auditors," by David Hilzenrath, *The Washington Post,* December 5, 2001, p. A01.

[5] The POB recently voted itself out of existence in protest over SEC Chairman Harvey Pitt's proposal to create a new self-regulatory body for the accounting industry.

[6] "Peer Pressure: SEC Saw Accounting Flaw," by Jonathan Weil and Scot J. Paltrow, *The Wall Street Journal,* January 25, 2002, p. C1.

[7] The case is described both in a May 12, 2000 letter from Rep. John Dingell (D-MI) to the SEC Chairman Arthur Levitt and in a May 22, 2000 *Business Week* editorial, "Why the Auditors Need Auditing."

[8] Ibid.

[9] "CPA's (and I am One) Can Reverse Their Losses," by Dave Cotton, *The Washington Post,* January 27, 2002, Op Ed.

[10] "Accounting in Crisis," by Nanette Byrnes with Mike McNamee, Diane Brady, Louis Lavelle, Christopher Palmeri, and bureau reports, *Business Week,* January 28, 2002, pp. 44–48.

B. It Must Be Adequately Funded

Whether the SEC or an SRO assumes responsibility for rulemaking, inspections, investigations, and disciplinary actions against auditors, the effort must be generously funded. Because the SEC's budget has for two decades failed to keep pace with the growth in its workload, the SEC today is severely under-funded. By passing SEC fee-reduction legislation last year without first raising the agency's budget to an appropriate level, Congress increased the likelihood that the agency will continue to be hampered by a shortage of funds in the future. The President's proposed fiscal year 2003 budget for the agency includes no significant increase in funding, not even enough to fund the pay parity provisions enacted last year. This raises serious concerns about the willingness of Congress and the Administration to adequately fund enhanced SEC oversight of auditors without robbing other high priority agency activities. One of the most favorable aspects of a proposal to create an independent regulatory body (provided it is unassailably independent) is that it offers the opportunity to ensure both adequate funding and the higher pay scales that make it easier to attract top investigation and enforcement staff.

C. It Must Have Rulemaking Authority

Chairman Pitt's SRO proposal appears to anticipate leaving authority for developing auditing standards with the AICPA. This is unacceptable. Rules on how to conduct audits clearly need to be strengthened and clarified. That is the job of an independent regulator, not an industry trade association. Either the SEC or an SRO operating under SEC supervision must be given authority to set both auditing and quality control standards. The AICPA, as a trade association, should have no Government recognized role in the regulatory process.

D. It Must Have Strong Investigative and Enforcement Authority

If oversight of accountants is delegated to an SRO, that SRO must have the ability to conduct routine, thorough inspections of audit firms to determine their compliance with auditing standards. It also must have extensive powers to conduct timely investigations of suspected abuses, including the power to subpoena witnesses and records from both auditors and the public companies they audit. And it must have the ability to impose meaningful penalties for violations.

It has also been suggested that, in cases where companies are forced to restate their earnings, a team of forensic accountants be dispatched immediately to investigate.[11] At the end of their investigation, they would issue a public report on what went wrong and what is being done to correct the problem. Possible recommendations might include revisions to accounting rules, revisions to auditing standards, changes in audit practices at the firm under investigation, etc. The SRO would then have authority to ensure that those changes were made. We believe this offers a good model for appropriate corrective action where problems are exposed either at a particular firm or in the system more generally.

REFORM PRIVATE LITIGATION LAWS TO PROVIDE A REAL DETERRENT TO WRONGDOING

Private litigation has long been viewed as an important supplement to regulation, since the threat of having to pay significant financial damages provides an incentive to comply with even poorly enforced laws. In 1995, however, Congress passed the Private Securities Litigation Reform Act, which significantly reduced auditors' liability in cases of securities fraud.[12] It did so, both by making it more difficult to bring a case against accountants and by reducing their financial exposure where they are found to have contributed to fraud.

It is not enough, in a securities fraud lawsuit, to show that an auditor made a materially false statement. You must also show that the auditor acted with an intent to defraud or a reckless disregard for the truth or accuracy of the statement. PSLRA set pleading standards with regard to state of mind that create a Catch 22 for plaintiffs' attorneys. They must present detailed facts showing the defendant acted with requisite state of mind, and they must do this before they gain access through discovery to the documents they need to establish state of mind. If plaintiffs cannot meet the pleading standards, the case is dismissed.

In addition to making it more difficult for securities fraud victims to bring private lawsuits against accountants, PSLRA reduced accountants' liability when they are found to have contributed to fraud. The primary way it accomplished this was by

[11] "Auditors Face Scant Discipline, Review Process Lacks Resources, Coordination, Will," by David S. Hilzenrath, *The Washington Post,* December 6, 2001, p. A01.

[12] PSLRA also all but guaranteed that Enron's victims will receive mere pennies on the dollar in any recovery.

replacing joint and several liability with a system of proportionate liability. Thus, accountants who are found to have contributed to securities fraud no longer have to fear being forced to pay the full amount of any damages awarded should the primary perpetrator be bankrupt. Under proportionate liability, the culpable accountant cannot be forced to pay more than their proportionate share of damages. As a result, according to noted securities law expert Professor John C. Coffee, Jr., accountants will rarely be forced to may more than 25 percent of the losses.[13]

PSLRA was also notable for what it did not do. It failed to extend the Federal law's very short statute of limitations for securities fraud of no more than 3 years from the time of the wrongdoing. This rewards those who are able to cover up their fraud for the relatively short period of 3 years and guarantees, for example, that some claims against Enron and Andersen will be time-barred. PSLRA also failed to restore aiding and abetting liability under securities fraud laws, which the Supreme Court's 1994 Central Bank of Denver decision eliminated as a potential cause of action. Thus, accountants can only be sued as primary perpetrators of securities fraud, not for their role in aiding and abetting that fraud.

The result is that the threat of private lawsuits now poses a diminished deterrent to accounting fraud. Restoring reasonable liability for culpable accountants should be part of any overall reform plan. This should include provisions: To enable plaintiffs to gain access to documents through discovery before having to meet the heightened pleading standards regarding state of mind; to restore joint and several liability where the defendant recklessly violated securities laws and the primary wrongdoer is bankrupt; to restore aiding and abetting liability for those who contribute to fraud but are not the primary culprit; and to extend the statute of limitations for securities fraud lawsuits.

The Independent Audit Must Be Backed Up By An Aggressive, Fully Funded SEC

In the wake of Enron's collapse, many have asked, "where was the SEC?" Given the SEC's responsibility for reviewing public company's financial disclosures, why had the agency not detected the company's problematic accounting earlier? One answer is that the SEC had not reviewed Enron's financial disclosures since 1997. The reason is that the agency is so understaffed it is only able to review a small percentage of filings each year.

This Committee recently heard testimony from the head of the General Accounting Office on the devastating effect that under-funding is having on the SEC's ability to perform its assigned tasks. The recent GAO report that formed the basis for that testimony looks at the growth in workload at the agency since the start of the 1990's, and documents the degree to which funding has failed to keep pace. It tells only half the story. The real damage to SEC funding occurred before the period covered by the report, in the 1980's, when staffing stayed virtually flat while the industry experienced dramatic growth.

In 1980, for example, there were just over 8,000 publicly-traded companies filing annual reports, according to a report commissioned in 1988 by the Securities Subcommittee of this Committee,[14] and there were 710 new registration statements filed. Excluding the staff for electronic filing and information services, 420 staff years were devoted to disclosure matters. As a result, the agency was able to review all transactional filings.

In 2000, the number of staff years devoted to full disclosure (again excluding the staff for electronic filing and information services), had dropped to 356, according to the SEC's analysis of the President's proposed fiscal year 2002 budget. As a result of diminished staffing, dramatic growth in the number of publicly-traded companies, and increased workload associated with review of initial offerings, "the percentage of all corporate filings that received a full review, a full financial review, or were just monitored for specific disclosure items" decreased to about 8 percent in 2000, according to the GAO report. Because of a dramatic drop-off in the number of IPO's in 2001, the SEC was able to complete "full or full financial reviews of about 16 percent, or 2,280 of 14,060 annual reports filed" last year, the GAO report found.

Among the financial statements that was passed over for review because of this staffing shortfall were the financial statements for Enron from 1998, 1999, and

[13] "The Enron Debacle and Gatekeeper Liability: Why Would the Gatekeepers Remain Silent?" Professor John C. Coffee, Jr., Adolf Berle Professor of Law, Columbia University Law School, testimony before the Senate Committee on Commerce, Science and Transportation, December 18, 2001.

[14] *Self-Funding Study,* prepared by the Office of the Executive Director of the U.S. Securities and Exchange Committee, submitted in partial response to the request of the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs (S. Rpt. 100–105), December 20, 1988.

2000. Although it is impossible to know whether more regular, more thorough reviews would have nipped the accounting problems at Enron in the bud, it is reasonable to think they might have. Certainly, it is irresponsible to so grossly under-fund the Federal regulators that they cannot hope to fulfill the important responsibilities assigned to them.

Last year, Congress had a historic opportunity to fix this problem. A decision was made not to use SEC-generated fees to fund other areas of the Government. As a result, the agency no longer had to compete with other Federal priorities in justifying its budget. Instead of taking that opportunity to dramatically boost agency funding, Congress approved a budget that required additional staffing cuts and passed legislation to reduce agency imposed fees to reflect that inadequate budget. The Members of this Committee fought to provide a funding boost, but those efforts were ultimately unsuccessful.

The collapse of Enron has focused new attention on the issue of SEC funding. Because of Enron, most of that attention is focused on staffing issues related to full disclosure and enforcement. These are important priorities that certainly need a funding boost, but similar trends have affected all areas of SEC responsibility. Think of what has happened in that time in the area of mutual funds or financial planning since the beginning of the 1980's. Think of how many more households are now participants in the markets and thus vulnerable to wrongdoing. The GAO report commissioned by this Committee has helped to make the case for across-the-board significant funding increases for the SEC. That case is even more powerful when the numbers from the 1980's are taken into account. The Members of this Committee must make a priority of undoing the damage of last year's fee reduction legislation and providing a budget for the SEC that is commensurate with its responsibilities.

Study Credit Ratings Agencies to Determine Why They Failed to Provide an Earlier Warning of Problems

Another troubling aspect of the Enron collapse is the failure of credit rating agencies to provide an early warning of trouble. In fact, both Moody's and Standard & Poor's still had Enron at investment grade until just 5 days before it filed for bankruptcy. According to a *Bloomberg News* account, Moody's had decided to downgrade Enron to junk in early November, but backed down in response to lobbying from Dynegy, which was then negotiating a takeover of Enron, and its bankers.[15] Although this raises serious questions about the objectivity of the ratings, it is unclear that an earlier downgrade would have changed things for investors. A credit rating is not just an isolated measure of a company's financial health. A downgrade may not just reflect the company's worsening financial status, it can trigger further financial woes, as it did for Enron.

We strongly encourage this Committee to conduct a further study of this issue to assess whether the operations of credit ratings agencies are adequate to ensure accurate ratings and, if not, what should be done to enhance the quality of ratings. That study should examine the extent to which recently announced changes by the ratings agencies are likely to provide the desired improvement. It should also examine whether lack of competition in the industry is contributing to the problem. We expect that a thorough review will identify areas in need of additional reform.

Study Measures to Address Securities Analyst Conflicts of Interest to Determine Whether Additional Protections are Needed

Credit ratings agencies were not alone in missing the warning signs. In early November, after the SEC had already announced it was looking into Enron's partnership transactions, ten of fifteen analysts who followed Enron still rated it as a "buy" or "strong buy." One reason, as the analysts are quick to point out, is that they were not getting good information from Enron's financial statements. Another is that Enron was apparently actively and intentionally misleading analysts about activity on its trading floor, for example.

However, this offers only a limited explanation. Red flags were there for those who were looking. And many now looking back—albeit with the benefit of 20–20 hindsight—have been able to point out obvious danger signs. These included wide discrepancies between the company's reported earnings and its retained earnings, negative cashflow of $2.56 billion in 2000 once proceeds from asset sales and other one-time activities not part of its core business were deducted, and actual revenues on energy trading that were a mere fraction of those that accounting rules let the

[15] "Moody's Enron Rating Shows Lack of Independence," Mark Gilbert, *Bloomberg News,* November 15, 2001.

company claim.[16] Surely it is analysts' job to look for just such clues and to probe deeper than the surface of company disclosures.

Another reason analysts may have missed these signs is that they simply weren't looking. After all, negative reports do not attract investment banking business, and Enron was clearly seen as a huge potential source of such deals. Since investment banking business is far more profitable than the retail sales business for large Wall Street firms, it is hardly surprising that those firms use their research arms to support their investment banking business. In the process, their research has become so compromised by conflicts of interest that it has no real credibility.

Recently, new rules have been proposed to address analyst conflicts of interest. They do so by attempting to limit the investment banking department's influence over research, limit analysts' investments in pre-IPO shares of companies in the industry they cover, limiting their purchase or sale of securities during a window of time around the release of a new research report, and prohibiting trades against their own recommendations, and requiring better disclosure of conflicts. We view this as a very positive step in the right direction, and will be commenting on the rules as they move through the approval process. However, we believe more should be done in several areas, including banning compensation for analysts that is tied in any way to investment banking profits, improving the clarity and relevance of required disclosures, and extending disclosure to recommendations by sales representatives to retail clients based on the company's research. We encourage this Committee to further study this issue to determine whether additional steps to enhance analyst independence may be necessary.

Protect FASB's Independence

In the wake of Enron's collapse, Arthur Andersen has tried to blame inadequate accounting rules—rather than its own poor performance as auditor—for Enron's less-than-transparent financial disclosures. This ignores the fact that Enron's financial statements have been shown to contain several violations of existing rules.[17] It also ignores Andersen's responsibility as auditor to ensure not just that Enron's disclosures complied with the letter of existing rules, but also that they presented an accurate picture of Enron's overall financial status. However, this is not an either-or proposition. It is, in fact, the case that Andersen failed in its responsibility as auditor *and* existing accounting rules are inadequate.

One reason is the inability of the Financial Accounting Standards Board to produce strong rules in a timely fashion when faced with entrenched opposition from large corporations and accounting firms. It is difficult to criticize FASB for moving too slowly on improved accounting rules governing special purpose entities, for example, when their past efforts to pass similarly controversial rules—regarding pooling of interest accounting for mergers, derivatives disclosures, and accounting for stock options—have met strong resistance, not just from business, but also from Members of Congress.

Something needs to be done to enhance FASB's independence. This is a difficult issue to tackle, since FASB is a private entity not subject to Government oversight. We applaud Senators Dodd and Corzine for tackling this issue in their recently introduced legislation. We believe the approach they have outlined—by giving the SEC greater say in FASB's agenda and by guaranteeing an independent funding source for FASB—offers the possibility of real progress. In addition, certain Members of Congress must recognize that they have played a key role in undermining FASB's independence in the past and should refrain from interfering inappropriately in the future.

Improve Corporate Governance Standards

Enron's independent board members, and particularly the board audit committee, have come in for considerable criticism for authorizing some of the company's more controversial partnership deals and for failing to ensure clear, accurate financial disclosures. While it may be unrealistic to suppose that board audit committees will ever be equipped to closely scrutinize and challenge the outside auditor's work, steps can and should be taken to enhance the independence and expertise of independent board members. This Committee could play a valuable role by examining what additional steps are needed to improve corporate governance practices.

[16] "How 287 Turned Into 7: Lessons in Fuzzy Math," by Gretchen Morgenson, *The New York Times*, January 20, 2002, Section 3, page 1.

[17] In his January 24, 2002 testimony before the Senate Committee on Governmental Affairs, former SEC Chief Accountant Lynn Turner outlined four areas of noncompliance with existing rules.

As a first step, exchanges must be pressed to adopt tough standards for determining the independence of board members and to require that a majority of board members for listed companies meet these standards.[18] A starting point should be the 1999 recommendations of an SEC-appointed blue ribbon commission. Among other things, that commission recommended that all audit committee members be financially sophisticated independent board members, and that at least one member have expertise in accounting or financial management.[19] Unfortunately, those standards have never been fully embraced by the major exchanges. Under its listing rules, for example, the New York Stock Exchange permits directors on the company payroll to serve on the audit committee, along with former employees and their families after a 3 year cooling off period, and board members with significant business relationships with the company, if the board determines those ties won't interfere with the board member's judgment.[20] If the exchanges fail to act voluntarily to improve board member independence standards, Congress and the SEC should call them to account.

Conclusion

The collapse of Enron has provided a clarion call for reform. It has exposed gaping holes in the investor protections we rely on to keep corporate managers honest. Enron is not unique. These same shortcomings apply to all publicly-traded companies. We are fortunate that so many company managers have remained committed to providing clear, accurate disclosures to investors. But we cannot rely exclusively on their integrity. We need a system that works even when company managers are greedy and overly aggressive. Congress can repair the gaps in the current system. It is of paramount importance that you do so.

PREPARED STATEMENT OF SARAH TESLIK

EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

MARCH 20, 2002

We are all Enron exhausted, so I will start with the bottom line.

Accountants sign off on financials that trick investors *because we let them.* CEO's pay themselves hundreds of millions of dollars, even when they bankrupt their companies, *because we let them.* Boards look the other way *because we let them.*

There are almost no consequences for individuals who commit corporate crimes. There are almost no consequences for board members, CEO's, auditors, analysts, rating agencies, and Government employees who fail to do their jobs. *Even honest people start behaving badly when there are no consequences.* Especially when the reward is hundreds of millions of dollars.

This is not an Enron issue. Enron is already old news—questions about Global Crossing, PNC, WorldCom, and A.C.L.N. all post-date it.

People will behave badly to get great wealth if the stock exchanges do not stop them. If the SEC doesn't deter them. If the FASB and the AICPA enable them. If prosecutors rarely go after them. And if you legislate loopholes.

The causes of this problem are not recent. Frauds are bigger and more frequent because the laws that were passed 65 years ago to protect shareholders have been steadily worn down by special interests. Indeed, our laws now protect executives, accountants, and financial wheeler/dealers at the shareholders' expense instead of the other way around. We are reaping the harvest of this multi-decade legal hijacking now.

Great civilizations in history crumble when special interests take control of Government machinery and use it for their benefit. I am well aware that these special interests are applying heavy pressure to each of you right now. If history is any guide, you will give in. I am begging you not to. The fact that we have had a good run of it the past 200 years doesn't mean we will in the future unless you reverse this erosion of average Americans' protections.

What most urgently has to be done? Let's start with the auditors.

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[18] In his January 24, 2002 testimony before the Committee on Governmental Affairs of the U.S. Senate, former SEC Chairman Arthur Levitt said independent board members should be precluded from receiving consulting fees, using corporate aircraft without reimbursement, accepting support of director-connected philanthropies, "or other seductions."

[19] "Accounting in Crisis," by Nanette Byrnes with Mike McNamee, Diane Brady, Louis Lavell, Christopher Palmeri, and bureau reports, *Business Week,* January 28, 2002, pp. 44–48.

[20] Ibid.

Right now we allow managers to pick and pay people to bless their work. If fifth graders picked their teachers, fifth graders would get A's. People invariably act in their self-interest.

Not only that. We allow auditors and managers to write accounting and auditing standards. If fifth graders wrote grading standards, all fifth graders would pass. People invariably act in their self-interest. So who can be surprised that we have loophole-ridden, outdated standards that permit amazing things—what is *permissible* under current standards is more amazing than what is not.

Not only that. We allow auditors to fund and run their own professional oversight. You *all* know better than that. No profession self-polices effectively. People invariably act in their self interest.

What should you pass? Legislation that aligns auditors' interests with shareholders' and that stops aligning auditors' interests with the managers whose numbers they review. Unless it is in auditors' financial interest to protect shareholders, it won't happen reliably enough. You also need legislation that keeps oversight and enforcement power free of undue influence by auditors and issuers. Specifically:

One: Require the board audit committee, not the managers, to hire the auditors. This is critical. Two: Fix the FASB's and the AICPA's accounting and audit standard setting systems with guaranteed funding and better accountability to investors—current accounting principles gave Enron crater-size loopholes. In other words fix the *system* for setting accounting and auditing standards, not just a couple of the worst products of the current systems. Three: Require CEO's, audit committee members and outside auditors to sign the financials as true and accurate—just like you and I sign our tax returns. (You think twice, don't you, when you sign?) Four: Remove nontrivial conflicts of interest—conflicts affect behavior. And five: Come down hard on individuals—not just companies—who break the law. If you merely fine audit companies for fraud, you simply increase a company's cost of doing business. Andersen settled case after case, wrote checks and moved on.

Relying on peoples' honor or professionalism will not work. Chinese walls never work. Independent bodies do not remain independent long. Unless you harness self-interest as the legislative motivator, you will keep getting misleading financials.

But auditors are only partly to blame for this mess. If your legislation focuses mostly on audit reform, it will be ineffective.

It is not the auditor's job to oversee the company. It is not the auditor's job to detect fraud, absent certain red flags. It is not the auditor's job to prevent self-dealing or make business decisions. It is not the auditor's job to set the tone at the top and say it is wrong to lend a rich CEO $341 million. It is not the auditor's job to create secure jobs and shareholder value. These are jobs for managers and boards.

Why have so many boards allowed terrible things to happen? Let me ask you this: If your staffers had absolute power to remove you from office, would you discipline them if they were stealing? Our system allows executives to pick the boards who are supposed to police them. So, although boards are supposed to represent shareholders, they do not. You participate in real elections so you care about your constituency. We shareholders should be so lucky.

Fixing this fundamental misalignment is more important to fraud prevention than auditor independence because a board's responsibilities are more critical to a company's health. Yet current laws, rather than helping shareholders keep companies accountable, do the opposite. I will give you a few examples.

- If a shareholder buys a mere 5 percent of a company's stock, he/she has to file forms as if the Government is tracking a pedophile rather than an owner. The only way a shareholder can avoid this is to file a form promising to be passive. I am not making this up. So, shareholders without expensive form-filing lawyers *have to promise to remain inert.* Large pension funds that might otherwise be willing to pressure a troubled company, and who do not seek control, remain inert rather than filing burdensome forms that bring litigation risks with them. These requirements should be reworked.
- The Government tells us what issues we can and cannot bring up with our own employees—company executives. The SEC decides what issues shareholders can raise for a shareholder vote. *Have any of you read these rules? They take almost every issue a shareholder ought to want to raise off the table:*
  - —We cannot ask about anything that is "ordinary business"—which covers almost everything we should care about.
  - —We cannot ask about anything that is extraordinary business either if an issue affects only a small part of the company.
  - —We cannot ask about the thing we should *most* want to ask about—the election of the company's actual board. I am still not kidding.

Many of the problems at Enron would be off limits for shareholders to raise under current rules. Worse, the SEC is free to, and often does, change its interpretations of these rules, without warning or recourse, so we do not know from 1 year to the next what we can ask.

- When the SEC *does* allow a shareholder to raise an issue for a vote, it requires the shareholder to send someone to the annual meeting, even though few companies require *their own directors* to attend and most shareholders vote by proxy and not in person. If the shareholder's representative is not there, the company can cancel the vote. So if you are disabled, have a job, are not rich or cannot travel, forget it.
- As if this is not enough, companies can, and do, move their annual meetings to hard-to-reach places, even foreign countries, so shareholders cannot get there. Annual meetings of major United States companies have been held in Russia—or in towns without airports in Alabama on Friday afternoons before holidays. I am not kidding.
- Managers can call off a shareholder vote on election day if they see they are losing. (Though a Council member sued a company over this recently and more or less won.) Can you imagine if a U.S. Senator could do this—people would howl.
- If a shareholder wins a majority of votes cast for its proposal, companies can, with few exceptions, ignore the vote. Most do. Some companies ignore the majority shareholder votes even when an issue passes year after year. This makes the shareholder franchise a joke.
- Shareholders used to get to vote once a year on directors. But this year AT&T and Comcast have agreed to bar shareholders from voting again on the board of the new company until 2005.
- Some shareholder ballot items are rigged. The New York Stock Exchange allows brokers to stuff ballot boxes and vote for management when shareholders with broker accounts do not vote. Most shareholders do not know this. Studies show this throws important votes. The SEC and NYSE ignore our pleas to fix this.

On this subject, I would caution you not to put the New York Stock Exchange in charge of any investor protections. The NYSE is a private sector corporation. It gets money from corporate executives—listing fees. Never expect private-sector bodies to act against those who fund them—they won't do it. Not surprisingly, the NYSE has, in my opinion, consistently used its Government powers to harm investors and protect managers, not the other way round. ***In my opinion, anyone who assigns investor protections to the NYSE doesn't want to protect investors.*** Democracies were designed to avoid precisely the problems we see over and over in this guild-like, Government-protected, reportedly highly profitable franchise.

So if you do want to make a real difference, what legislation do you pass?

We need better and immediate information about companies' executive compensation practices and directors' and CEOs' buying, selling, borrowing, and hedging activities. And we need better ways to control this compensation—votes on all stock option plans and an ability to put up board candidates if existing boards are giving away the shop. Fraudulently calculated pay needs to be returned.

Why is all this so important? Because if we cannot control our employees' compensation, even honest people will gradually pay themselves more and more. It is happening all over. Power corrupts. In extreme cases companies become Ponzi schemes. Executives siphon money out in mega option grants and companies crash.

There is a reason that nearly a quarter of major-company CEO's get their companies to give them huge loans—loans as high as a third of a billion dollars to one person. There is a reason these loans are often forgiven, subsidized, and/or used to hide CEO stock dumping. When shareholders' hands are tied behind their backs and key information stays secret, or stays secret until it is useless, executives get more and more generous with themselves. They do it because they can.

If you curb executive compensation abuse, frauds become less profitable to fraudsters. Money is the main motivator. Focus on it.

Neither the SEC nor the NYSE has used the powers they already have to address this problem adequately; if it doesn't come from you, it won't happen.

What else? Senator Nelson's bill gets at many of the issues I have raised today. It requires that companies disclose directors' conflicts better—something we asked the SEC to do years ago but which just sits over there. In fraud after fraud we discover undisclosed director conflicts. There is no excuse for hiding this critical information. Nelson's bill also gets at board independence effectively because it uses a real-world definition of independence, not a weak definition, like those used by the NYSE and some companies.

At our meeting next week Council members will be discussing legislative language that would make it easier for shareholders to put director candidates on the com-

pany's proxy and get issues on company ballots. Why do you let companies ignore our majority votes? Why does the NYSE throw shareholder votes by letting brokers, who are not shareholders, vote? Shareholders will keep markets clean, at no Government expense, if only you would let us by removing our handcuffs.

Corporate governance should be at the heart of this debate, not at the periphery. Structures to stop frauds in the first place, rather than efforts to catch them when they arrive in auditors' hands, should be the starting point. Better information is useless without ways to act on it. We need both.

Finally, enforcement. There is too little enforcement and too much of it targets *companies* and not human wrongdoers. Five years from now when this hubbub is history and you are an auditor or a director being pressed privately by management to go along with a fraud, will you be more deterred by the thought that your company may be fined or by the thought you may go to jail?

When you punish companies, you punish innocent shareholders, the victims. I am therefore very pleased by the enforcement proposals in the Leahy–Daschle bill. Fraudsters will do anything you let them. Please stop letting them. And please do not go for mid-level scapegoats. Those who get the big bucks need to shoulder the responsibility. A CEO or a director going to jail would be a corporate governance shot heard round the world.

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The Council is a not-for-profit association of large institutional shareholders. It includes corporate pension funds, Government pension funds, labor funds, endowments, international pension funds, entities such as the World Bank and TIAA–CREF, money managers and financial institutions. Its members manage over $2 trillion and represent millions of beneficiaries, employees, and voters. The Council is funded solely by members' dues. It is nonpartisan. It addresses investment issues exclusively.

PREPARED STATEMENT OF THOMAS A. BOWMAN, CFA

PRESIDENT AND CHIEF EXECUTIVE OFFICER

ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH

MARCH 20, 2002

Introduction

Good morning, I am Thomas A. Bowman, President and Chief Executive Officer of the Association for Investment Management and Research® (AIMR®) and a holder of the Chartered Financial Analyst® (CFA®) designation. I would like to thank Chairman Sarbanes and other Members of the Committee for the opportunity to speak on behalf of the more than 150,000 investment professionals worldwide who are members of AIMR or are candidates for the CFA designation.

AIMR is a nonprofit professional membership organization with a mission of advancing the interests of the global investment community by establishing and maintaining the highest standards of professional excellence and integrity. AIMR is most widely recognized as the organization that conducts qualifying examinations and awards the CFA designation. In 2002, over 100,000 candidates from 143 countries have registered to take the CFA exam, which is administered annually in more than 70 countries worldwide.

Although not a license to practice financial analysis or investment management, the CFA charter is the only globally recognized standard for measuring the competence and the integrity of financial analysts. The CFA Program consists of three levels of rigorous examinations, which measure a candidate's ability to apply the fundamental knowledge of investment principles at a professional level.

To be awarded the CFA charter, a candidate must pass sequentially all three levels of the examinations, totaling 18 hours of testing. They must have at least 3 years of relevant professional experience working in the investment decisionmaking process and fulfill other requirements for AIMR membership. All AIMR members, CFA charterholders, and candidates must sign and submit an annual Professional Conduct Statement that attests to their adherence to *The Code of Ethics and Standards of Professional Conduct (*AIMR *Code and Standards).* A violation of the AIMR *Codes and Standards,* including failure to file the Professional Conduct Statement, can result in disciplinary sanctions, including suspension or revocation of the right to use the CFA designation.

The AIMR *Code of Ethics* requires AIMR members to always:

- Act with integrity, competence, dignity, and in an ethical manner when dealing with the public, clients, prospects, employers, employees, and fellow members.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on members and their profession.
- Strive to maintain and improve their competence and the competence of others in the profession.
- Use reasonable care and exercise independent professional judgment.

General Remarks

The issues this Committee is addressing—corporate governance; integrity and adequacy of the U.S. financial reporting and disclosure system; the effectiveness of certified financial audits and regulatory oversight; insider trading and conflicts of interest among securities underwriters and financial analysts—are all extremely important to AIMR constituents. Although most AIMR members are not subject to the conflicts of interest that financial analysts working for Wall Street and similar "sell-side" firms face, all investment professionals are disadvantaged in their ability to conduct research, make investment recommendations to, or take investment action for, their investing clients by some companies' exploitation or disregard of financial accounting standards and the important principle of disclosure, and by any failure of regulatory oversight to enforce those standards.

Enron's alleged exploitation of financial reporting rules is remarkable only for its egregiousness and its scale. We believe Enron is not an isolated case of accounting abuse. The current environment allows any company to play games with their financial reports to a greater or lesser degree. Research commissioned by the Financial Executives Institute (FEI), a private, nonprofit organization of company executives, supports our belief. This research shows that, from 1998 to 2000, 460 companies restated various financial statement items, including many that were material. However, with the amount of flexibility that financial reporting standards allow, we are surprised that any company would resort to fraud to mislead even the most sophisticated investors.

Adequacy of Financial Accounting Standards and the Regulatory Oversight System

We believe that the Financial Accounting Standards Board (FASB) has the will to provide appropriate accounting and disclosure for the benefit of investors, but external pressures have prevented it from doing so. The existing standard on accounting for share-based compensation is a perfect case in point. However, there are several key areas with deficient rules that must be addressed immediately if investor needs are to be met. Such rules are an engraved invitation to the kind of abuses alleged at Enron. We offer the following examples:

Consolidations and Off Balance Sheet Assets or Liabilities

For the past 20 years, AIMR has advocated that *all* off balance sheet activities be reported in the parent company's financial statements. This includes activities such as leasing transactions as well as consolidation of subsidiaries, special purpose entities, joint ventures, and partnerships. Current accounting rules are inadequate because they have "bright lines" that allow companies to tailor their transactions to be on or off balance sheet. For example, subsidiaries are not consolidated unless the company owns more than 50 percent. Consolidation on an SPE requires more than 97 percent ownership. Partnerships and joint ventures can escape consolidation altogether. Rules for recognition of liabilities under leasing arrangements allow companies to keep significant assets and liabilities off the balance sheet and can distort the reporting of operating cashflows and earnings.

Financial Assets and Liabilities

As the market in derivatives and other complex financial instruments has grown, we have argued for reporting of financial assets and liabilities at fair value, rather than historic cost. Given the volatility of these instruments, we believe that reporting these assets or liabilities at their fair value is the only way to understand their risks and rewards. Corporate objection to this change has been fierce. The resulting standards require some instruments to be recorded at fair value but others not; some changes in value are recorded in earnings but others not. Even when fair value changes are recorded in earnings, companies need not disclose in what income statement item they appear. This situation turns financial analysis into an impossible game of hide-and-seek.

Investors also need more informative disclosures regarding financial assets and liabilities. In response to rule proposals by the Securities and Exchange Commission (SEC), the AIMR argued for disclosure of sensitivity analysis to allow investors to understand fully the potential risks of these instruments to changing market condi-

tions. Companies lobbied heavily against improved disclosures. The Senate Committee on Banking, Housing, and Urban Affairs held hearings at which the FASB, SEC, and AIMR testified in support of the SEC rule proposal, but corporate issuers opposed the improved disclosures. The regulations that were implemented give companies too much flexibility in the type of disclosure. They are generally so simplistic as to be all but useless to investors.

Share-Based Compensation

Stock options and other equity-based compensation have become an important part of executive compensation in the United States, particularly in new and growing industries. Such compensation should be a way to align management and shareowner interest, but unfortunately has led to earnings manipulation to improve share price. Contrary to what managements would have investors believe, stock options are not "free" or of "little or no value." If so, why would management accept them in lieu of cash? In fact, exercise of executive stock options reduces external shareholder interest and increases management's interest, generally on unfavorable terms to shareholders. Nor do these options better align management and shareholder interests, since research shows that managers are more apt to sell the shares they receive when options are exercised.

In 1994, to its credit, the FASB was prepared to issue a new rule to require recognition of compensation expense for stock options. Heavy corporate lobbying and legislative intervention, however, led the FASB to allow footnote disclosure rather than recognition. Disclosure is no substitute for recognition and measurement. A recent AIMR survey shows that 83 percent of responding fund managers and analysts support recognition and believe that current disclosures are inadequate and difficult to use.

Pro Forma Earnings

Another creative way in which managements mislead investors and manipulate investor expectations is by communication of "*pro forma* earnings," company-specific variations of earnings, or "earnings before the bad stuff." With all its deficiencies, we believe that earnings data based on Generally Accepted Accounting Principles (GAAP) are still the most useful starting point for analysis of a company's performance. Analysts and other investors at least know how GAAP earnings are computed and, hence, there is some comparability across companies. We believe GAAP earnings should always be displayed more prominently than non-GAAP earnings data.

Unfortunately, just the opposite seems to be the norm, particularly in press releases where *pro forma* earnings get the most emphasis and GAAP earnings may not be mentioned at all. GAAP earnings and associated balance sheet may only become available to investors in SEC filings 1 to 2 weeks after *pro forma* earnings are announced. While *pro forma* earnings can be helpful supplemental information for analysts, the practice of providing *pro forma* earnings is widely abused. Companies selectively exclude all sorts of financial reporting items, including depreciation, amortization, payroll taxes on exercises of options, investment gains and losses, stock compensation expenses, acquisition-related and restructuring costs. Mr. John Bogle, the respected investment professional, recently noted in a speech to the New York Society of Securities Analysts, "In 2001, 1,500 companies reported *pro forma* earnings—what their earnings *would* have been if bad things hadn't happened." We recommend that either the FASB or SEC curtail this practice or ensure that *pro forma* earnings data never have more prominence than GAAP earnings in company communications.

Inappropriate legislative intervention in the standard setting and the regulatory processes has resulted in less transparency for investors in preference to corporate interests. We hope that such intervention will cease. The FASB must be allowed to be independent in its decisionmaking and be supported with adequate funding to proceed quickly and expeditiously to address both longstanding and emerging issues. The FASB cannot only be reactive to financial reporting failures; it must be proactive and continuously review and update its standards. We are concerned that its current rush to "fix" the existing standard for Special Purpose Entities (SPE) will be only a "Band-Aid" for SPE's rather than a solution to the larger, underlying problem of off balance sheet liabilities.

We do not believe that the SEC's regulatory oversight and enforcement of FASB's standards and its own regulatory rules are consistent or adequate. We also observe that its attitude toward corporate/issuer versus investor/user interests changes when the SEC's leadership and membership changes. Even when the SEC has been concerned with investor needs, it has severely lacked the economic and human resources to address all the issues, including those for which here there are no accounting or disclosure standards.

For example, in 1996, SEC staff approached AIMR about a project on disclosure requirements for asset-backed securities. Considerably less disclosure is mandated for these securities than for equity securities, either in securities offering documents or in subsequent continuous disclosure filings. To respond to the SEC's request, we convened a task force of interested and knowledgeable AIMR members who expressed concerns about their ability to fulfill their fiduciary responsibilities in the current environment and were excited that better disclosure might be forthcoming. They were anxious to communicate the investor needs to the SEC. The task force drafted a formal response to the request, outlining the information that investors need to make good initial and on-going decisions about these securities; why the information was needed; and how it would be used. That is the last that we have heard from the SEC about this project. In answer to our subsequent inquiries about the project's status, we were told that the staff members assigned to the project had left the SEC and the project would be resumed when new staff was assigned. We have heard nothing since. We still consider this to be an important project and an important area where critical investor needs for information are not being met.

Audits and Auditors

Financial statements should be the single best source of information about a company, its financial health and its prospects for the future. The Investors use the information they contain as an analytical tool, as a "report card" of management's performance and accountability and as an early indicator of the company's future success or potential failure. Financial statements are an indispensable source of information for shareholders and investors, employees, lenders and suppliers, customers, governments, and regulatory agencies. But these users of financial statements must have assurance that the information is reliable and credible.

Such assurance begins with management, which must establish a strong internal control system to facilitate reliable financial reporting and assist the company in complying with applicable laws and regulations. But high quality internal controls will not guarantee a company's success, reliable financial reporting, or compliance with laws and regulations. Decisionmaking can still be faulty and simple errors and mistakes can creep in. Controls can be circumvented by collusion of two or more people and management generally has the ability to override the system. The chief executive officer, therefore, must accept "ownership" of the system and set a tone that strengthens the integrity and ethics of the control environment. Of particular importance to the process are the financial officers and their staffs.

Although financial statements are the product and responsibility of management and a high quality internal control system is critical, no external party plays as important a role in the achievement of reliable financial reporting than the independent certified public accountants. They must bring an independent and objective view to management and the board of directors. Auditors bring assurance about the reliability and credibility of financial statements to a higher level, and attest to their fairness in conformity with Generally Accepted Accounting Principles.

Unfortunately, although internal controls are the first line of defense against fraudulent or misleading financial statements, the auditor does not generally focus on their adequacy. Therefore, one of our recommendations is that auditors be required to test and report on the effectiveness of internal controls as part of their audit responsibilities. An assurance about internal controls should be reported publicly as part of the audit opinion. We also believe that required audit procedures must be improved to ensure the auditor has a greater ability to detect fraud.

Independence is an essential element in an auditor's ability to perform effective audits, disclose improper accounting choices, whether in accordance with GAAP or not, and enhance the credibility of financial statements. Arthur Andersen, Enron's auditor, has come under such intense pressure that it may not survive. But at some time, all of the major international, "Big 5," accounting firms have been charged with a lack of independence, similar in kind if not severity. Investment professionals have understood these conflicts for some time and have viewed auditors as advocates for their corporate clients rather than for shareholders and for investors. One only has to read audit firm advertisements or a description of their business to understand that auditors support their *clients'* interests. The following descriptions have been copied from the websites of two of the Big 5 audit firms, but are indicative of all:

- "A global leader in professional services, Ernst & Young helps companies in businesses across all industries—from emerging growth companies to global powerhouses—identify and capitalize on business opportunities. Our 84,000 people in more than 130 countries worldwide can implement a broad array of solutions in audit, tax, corporate finance, transactions, online security, enterprise risk management, the valuation of intangibles, and other critical business-performance

issues. We audit 113 of the Fortune 500 companies and are one of the largest providers of tax services in the world. Our worldwide revenues for the fiscal year ended June 30 were $9.9 billion."

- "Deregulation, privatization, emerging markets, and quantum improvements in telecommunications and information technology have radically altered the business landscape creating complex problems that are challenging chief executives. To help you meet these demands, . . . [PricewaterhouseCoopers'] Assurance and Business Advisory Services (ABAS) practice in the United States offer you a broad range of innovative and cost-effective solutions, drawing on our worldwide resources we provide Assurance on the financial performance and operations of your business. Through our Global Risk Management Solutions, we help you manage the totality of risks—financial, operational and systems, and strategic—and thereby improve your financial and business performance. We provide Transactions Services as a core part of mergers, acquisitions, divestitures, joint ventures, spinoffs, and strategic alliances. We provide Services such as Middle Market Advisory Services that utilize sophisticated business solutions to help clients maximize their growth potential and remain competitive."

AIMR members are concerned about the effectiveness of audits and the independence of auditors. A subcommittee of the AIMR U.S. Advocacy Committee has dedicated itself to responding to initiatives of the Independence Standards Board and others on audit issues. In September 2000, we testified before the SEC on this important issue. We believe that independent auditors, by helping to maintain the credibility of financial information, also help to maintain the overall stability and strength of financial markets. Reliable and credible information ensures that capital is allocated to those investments that create the highest returns commensurate with the risks and uncertainties of the investment.

To facilitate our responses to proposed changes to auditor independence requirements, AIMR conducted three separate surveys of AIMR members and CFA candidates who work as either financial analysts or portfolio managers. Each survey addressed one of the following issues: Financial ownership and interests in audit clients held by audit firms, partners or other audit professional staff; nonaudit services provided to audit clients; and employment relationships involving personnel with the audit firms and clients. A total of 2,273 individual responded to the three surveys sent to AIMR members working in the United States.

There were 875 respondents to the survey on financial ownership and interests. Over 85 percent of the respondents indicated that audit firms and audit partners should be prohibited from owning shares in their audit clients, and over 77 percent indicated that holdings in the audit client should also be prohibited for professional staff on the audit. There was less concern about other partners or professional staff.

Over 50 percent of respondents to the survey on nonaudit services indicated that providing the following services impairs independence:

(1) Asset valuation and appraisal (65 percent).
(2) Accounting, payroll, and other outsourced activities (62 percent).
(3) Legal services (62 percent).
(4) Executive compensation consulting and training (61 percent).
(5) Treasury management (60 percent).
(6) Risk management (59 percent).
(7) Other management consulting (53 percent).

We believe that prohibiting all nonaudit services would be too severe and that some, such as tax planning and compliance or information systems design, may provide beneficial synergies to the audit.

Our primary concern is actually with the basic concept of audit firms marketing nonaudit services, even to nonaudit clients. The evolution of the audit firm into a multi-service business advisory firm, providing consulting and management advisory services in addition to tax and audit services, has shifted the emphasis of the firm's practice from the original purpose of the audit and formation of a professional opinion on the financial statements. This is entirely understandable; audit services are extremely price sensitive and nonaudit services are far more profitable. The audit is viewed within the firm as a commodity or "loss leader" and nonaudit partners and activities have more value and prestige.

We recommend the following enhancements to existing rules regarding auditor independence:

- An audit firm should be prohibited from having any ownership interest in an audit client unless this interest is held in trust by an independent trustee, such as a pension plan managed by a third party or mutual fund. This prohibition should also apply to audit clients having a financial interest in the audit firm.

- Certain nonaudit services, that is, legal services or appraisal/valuation services, should be prohibited or severely limited in scope, and adequate safeguards must be in place to segregate the audit practice from nonaudit services.
- Full and fair disclosure of all conflicts of interest between a client and its auditors must be required. Such disclosures would include information about fees for nonaudit services, the nature of nonaudit services provided, and post-audit employment of audit firm professionals by the audit client.

Corporate Governance

Corporate governance and the influence of investors in the governing process are issues of growing importance in the global capital markets. Good corporate governance protects the interests of shareholders and investors. It is critical not only to the development and integrity of financial markets, but also to investor confidence in these markets, giving investors an incentive to risk their capital. Given the magnitude of investment in the United States, the potential power and influence that institutional investors, representing millions of individuals, can wield over the companies in which they hold interests is staggering.

Corporate governance should foster transparency: Full disclosure of the conditions—risks and opportunities—to which investors in a particular market, or a particular company, are subject. At the macro level, these conditions encompass a market's various legal, financial reporting and disclosure, regulatory and supervisory standards and regimes. At the micro level, these conditions include an individual company's financial performance and outlook, as well as full disclosure of how a company is governed, and the qualifications, responsibilities and compensation of its board of directors. Even more importantly, a good corporate governance framework provides evidence to shareholders and potential investors of the independence of the board of directors. Only when companies exhibit good corporate governance will investors have the confidence to provide them with the capital they seek.

A framework for corporate governance must encompass the duties, responsibilities and powers of the board of directors, the procedures for selecting members of the board, and the process for making those decisions that materially impact a company's value. Such decisions include whether to merge with a competitor, to divest certain assets, or to repurchase equity. Essentially, frameworks or codes for corporate governance are designed to help boards fulfill their fiduciary duty—doing the right thing, even when no one is looking—thereby earning the trust, confidence, and capital of investors, especially outside investors.

Best practice frameworks exist and can be applied. Even markets that already recognize the need for good corporate governance can benefit from improvement to their frameworks. To that end, we recommend the following best practices in corporate governance:

- At least half of the directors should be independent, nonexecutive officers of the corporation, even if one group owns the majority of outstanding equity shares.
- Shareholder voting rights and meeting rights should ensure that one share has one vote, and decisions are not made by a show of hands.
- The following three independent committees should be appointed by the Board, and not management:
  —Audit
  —Nominations
  —Compensation

Standard setting bodies increasingly recognize that, to govern effectively, board members need to have a relatively high level of knowledge of the corporation's business activities, in addition to its financial condition. For example, the National Association of Corporate Directors has issued a set of new guidelines for enhancing the professionalism of board members. We support the following qualifications and responsibilities for directors and recommend their adoption:

- Directors should be active participants and decisionmakers in the boardroom, not merely passive advisers or "rubber stamps" for management proposals.
- Directors should limit their number of board memberships.
- Directors should limit their length of service on a board to 10 to 15 years so that new directors with fresh insights and a renewed independence can be elected.
- Directors should immerse themselves in both the company's business and its industry while staying in touch with senior management.
- Directors should know how to read a balance sheet and an income statement and understand the use of financial ratios so they can do their own analysis of the company's performance and detect early warning signs of emerging problems.
- Directors should own a significant equity position in the company.

We also recommend that institutional investors play a greater role in corporate governance. The fiduciary duty of pension fund sponsors and trustees and mutual fund managers entails duties of care and loyalty to their investors and clients. It entails an obligation to add value to clients' investments and protect their interests in the long-term health of the companies in which they invest. This is particularly important for passive or index fund managers who may have significant positions in a company's securities but do not have the flexibility to influence corporate management by simply selling shares. As the founder of Deutsche Bank, Mr. George Siemens once said, "If one cannot sell, one must care."

We recommend that institutional investors assume a role that ensures that corporate policies serve the best interest of a corporation's investor-owners. Although we would not expect that institutional investors would seek involvement in the day-to-day operations of the companies in which they invest, we believe that institutional investors should recognize the need for conscientious oversight of and input into management decisions that may affect a company's value. Although institutional investors should follow clear and transparent general voting guidelines, available to all investor-clients, in voting their proxies, they must also recognize the need to review all votes individually and not permit minority shareholders to be treated unfairly.

Ideally, we would like to see a private-public partnership of investors, financial industry participants, and Government regulators that would unite to help eliminate market barriers by establishing, implementing and maintaining corporate governance standards that mandate transparency, timeliness and accuracy of corporate financial reporting. For these standards to work and offer real investor protection, there must also be enforcement of fiduciary laws and standards through effective market monitoring and surveillance by regulators as well as self-regulatory organizations. The standards and their enforcement work together to create a level playing field for all market participants—foreign and domestic—and to encourage competition in the market. The end result is better protection for investors, instilling them with confidence, and giving them more and better investment choices and increased access to opportunities.

Analyst Independence

To reiterate, the AIMR mission is to advance the interests of the global investment community by establishing and maintaining the highest standards of professional excellence and integrity. Clearly, the erosion of investor confidence in the independence and objectivity of "Wall Street" research reports and recommendations does *not* enhance those interests and could seriously harm the reputation of the entire investment profession. We believe that all market participants have a mutual responsibility to create and maintain an environment that enables "Wall Street" research analysts to fulfill their responsibilities with independence and objectivity. Only if the investing public believes that the information available to them is fair, accurate, and transparent can they have confidence in the integrity of the financial markets and the investment professionals who serve them.

Investment professionals expect the companies they research, recommend, or whose securities they hold to provide full and fair disclosure. They should expect no less of themselves. But just as investment professionals would not make an investment recommendation or take investment action based on earnings information alone, so too investors should not make investment decisions based on a simple, one-dimensional rating.

AIMR is committed to the principle that the best interests of the investing client must always take precedence over the needs of the research analyst, investment manager, and his or her employer. With respect to relationships with clients and prospective clients, *The Code of Ethics* and *The Standards of Professional Conduct* of our organization specifically require AIMR members to:

- Exercise diligence and thoroughness in making investment recommendations.
- Have a reasonable and adequate basis, supported by appropriate research and investigation, for such recommendations or actions.
- Use reasonable care and judgment to achieve and maintain independence and objectivity in making investment recommendations or taking investment action.
- Act for the benefit of their clients and always place their clients' interests before their own.
- Distinguish between the facts and the opinions in the presentation of investment recommendations.
- Consider the appropriateness and suitability of investment recommendations or actions for each client.

AIMR members are individual investment professionals, not firms. They work in various capacities in the global investment industry. Approximately 9,000 (18 percent) of our members work for "Wall Street" or similar firms worldwide, known as the "sell-side" (for example, broker-dealers and investment banks). Those who work as research analysts for these firms, whose independence and objectivity have been questioned, are an even smaller percentage of AIMR members. In contrast, more than 65 percent of AIMR members work as investment advisors or fund managers for the "buy-side," the traditional, and still the primary, purchasers of "sell-side" or "Wall Street" research. They are not subject to most of the conflicts of interest faced by sell-side analysts.

Based on our experience in setting ethical standards for AIMR members, I can tell you that ethical standards are most effective when developed by the profession and voluntarily embraced rather than externally and unilaterally imposed. In making your determination about whether to trust the private sector to manage analyst conflicts of interest effectively, I ask that you consider AIMR's commitment to developing and recommending practical, long-term solutions for the conflicts of interest and ethical dilemmas that Wall Street analysts face.

It is important to recognize that the conflicts that Wall Street analysts face are not new. They have, however, been magnified in an environment that emphasizes short-term performance and where profits from research and brokerage are minuscule compared to profits from investment banking and other corporate finance activities. In this environment, penny changes in earnings-per-share forecasts have dramatic effects on share prices. And in this environment, individual investors rely on analyst ratings or on recommendations without even reading their research reports—in contrast to institutional investors, who learn what they can from the report, judge the validity of the methodology and analysis, and ignore the ratings. It is more than unfortunate—it is untenable—that the serious business of investing one's assets for retirement has become a "sport," like horse racing where investors are always looking for "hot tips." Unfortunately, investments are not "sure things." Many, in fact, are "long shots." Investors must be cautioned about making investment decisions based on ratings alone.

The analysts' responsibility is to conduct thorough and comprehensive research and then to form an opinion about the future prospects for a security. This opinion is communicated by a recommendation or rating based on their firm's rating system. The resulting report is then "sold" to investing clients, primarily institutional investors, who direct brokerage to the firm. Unfortunately, this responsibility must be carried out despite sometimes opaque and misleading financial information, designed to hide the "bad news" while promoting the "good news." Unless analysts' clearly see through companies' bending of accounting rules, the positive bias in financial statements can influence analysis.

Besides this bias, are Wall Street analysts sometimes *pressured* to be positive about the prospects of the companies they follow? Yes. But these pressures come from many sources, and not all from their employers. Effective solutions to these pressures can only be developed when all the pressures and those who contribute to them are identified and addressed.

In the wake of Enron, the particular conflict posed by Wall Street analysts' involvement in their firms' investmentbanking activities continues to be the focus of media attention. However, even if Wall Street investment banks were prohibited from selling research to investing clients or if in-house research analysts were prohibited from collaborating with investment banking, the problem of analyst objectivity would not be solved. As long as securing corporate clients for investment banking is in part dependent upon keeping management "happy" with analyst "buy" recommendations, investment banking will inevitably seek out those research analysts, independent or not, who are favorable toward the client company.

Collaboration between research and investment banking is by no means the only conflict that must be addressed if we are to provide an environment that neither coerces nor entices analysts to bias their reports and recommendations. For example, strong pressure to prepare "positive" reports and make "buy" recommendations comes directly from corporate issuers, who retaliate in both subtle, and not so subtle, ways against analysts they perceive as "negative" or not "understanding" their company. Issuers complain to Wall Street firms' management about "negative" or uncooperative analysts. They bring lawsuits against firms—and analysts personally—for negative coverage. But more insidiously, they "blackball" analysts by not taking their questions on conference calls or not returning their individual calls to investor relations or other company management. This puts the "negative" analyst at a distinct competitive disadvantage, increases the amount of uncertainty an analyst must deal with in doing valuation and making a recommendation, and disadvantages the firm's clients, who pay for that research. Such actions create a

climate of fear and intimidation that fosters neither independence nor objectivity. Analysts walk a tightrope when dealing with company managements. A false step may cost them an important source of information and ultimately their jobs.

Institutional clients, the "buy-side," have their own vested interests in maintaining or inflating stock prices and, thus indirectly, recommendations and ratings. Fund managers do not want to be "blind-sided" by a change in recommendation that might adversely affect their portfolio performance, and hence their compensation. When they find out about a negative analyst, the "buy-side" has been known to "turn in" that analyst to the subject company.

An investment professional's personal investments and trading pose another conflict, one that AIMR addressed extensively in a 1995 topical study that now forms an important component of the AIMR *Code and Standards.* We do not believe that it is in clients' best interests to prohibit Wall Street analysts, or other investment professionals for that matter, from owning the securities of the companies they follow or in which they invest their clients' money. Rather, permitting personal investments better aligns analyst and investor interests ***as long as strict, and enforced, safeguards are in place that prevent analysts from front running their clients' or their firms' investment actions, and that prohibit analysts from trading against their recommendations.***

The content and quality of research reports and investment recommendation is also affected by this simple fact: Analysts are human. No matter how experienced, expert, or independent, Wall Street analysts do not have crystal balls; they are not infallible. Even in the absence of fraud, the more opaque a company's disclosures and the more reticent company management, the more difficult it is for the analyst to predict changes in the company's fortunes. Much has been made about some Wall Street analysts' failures to change their recommendations as the price of Enron began and continued to fall. But I wish to remind the Committee that many "buy-side" investment managers with major positions in Enron, who do not suffer from the alleged investment banking conflicts of Wall Street analysts, have admitted that they too could not predict soon enough the downturn in Enron's fortunes or the speed with which it would spiral into bankruptcy. These failures were not due to a lack of independence, skill, or due diligence, but to the lies allegedly told them by a company that apparently betrayed their trust.

I have recommended improvements to accounting standards, regulatory enforcements, auditor independence, and corporate governance. I can do no less for analyst independence. In recommending specific measures to increase the likelihood that investors will receive unbiased recommendations from Wall Street, I am seeking to inform as well as protect those investors who may not be aware of the pressures on Wall Street analysts from the sources I cited and the limitations in analysts' ability to make foolproof recommendations. This is especially true for those investors who receive shorthand information through various media outlets rather than by purchasing and reading the full research report directly from the Wall Street firm. Surely, no one would recommend that individuals make important decisions, such as taking medication or buying a home, solely on what they read in the press or hear on television. How much more critical then are the investment decisions that can adversely affect their own and their families' financial welfare?

We do not dispute that some Wall Street firms may pressure their analysts to issue favorable research on current or prospective investment banking clients, or that this practice must stop. These and the other forces I mentioned create an environment replete with conflicts of interest, one that undermines the ethical principles upon which the AIMR and the CFA Program are based. We condemn all who foster or sustain it.

However, the relationship between research and investment banking is symbiotic and an important part of the firm's due diligence when evaluating whether or not to accept a company as an investment banking client. Although we do not believe that this collaborative relationship is inherently unethical, it poses conflicts that can lead to serious ethical problems for analysts, especially when a large portion of the firm's profitability comes from investment banking. If such collaborations are allowed, investment banking firms must take particular care to have policies and procedures that minimize and manage all real and potential conflicts, and that fully and fairly disclose them to investors.

To effectively manage these conflicts, AIMR is currently developing proposed standards to improve research objectivity. These standards include the following recommendations:

- Firms must foster a corporate culture that fully supports independence and objectivity and protects analysts from undue pressure from issuers and investment banking colleagues.

- Firms must establish or reinforce separate and distinct reporting structures for their research and investment banking activities so that investment banking never has the ability or the authority to review, approve, modify, or reject a research report or investment recommendation.
- Firms must establish clear policies for personal investment and trading to ensure that the interests of investors are always placed before analysts' own.
- Firms must implement compensation arrangements that do *not* link analysts' compensation directly to their work on investment banking assignments or to the success of investment banking activities, but rather directly link, *and heavily weight,* analysts' compensation to the quality and the comprehensiveness of their research and the accuracy of their recommendations.[1] (Only when compensation arrangements explicitly include quantitative measurable attributes, such as performance of stock recommendations and accuracy of earnings forecasts, as well as qualitative characteristics, that reference the quality and comprehensiveness of the research on which recommendations are based, will analysts have the proper incentives to do truly independent, objective, and high quality research.)
- Firms must make prominent and specific, rather than marginal and "boilerplate," disclosures of conflicts of interest. Such disclosures must be written in "plain English" so that they are accessible and that they are understood by the average reader or listener.

Enhanced disclosures are a key part of the AIMR proposal. At a minimum, we believe that Wall Street analysts must disclose—and their firms must require them to disclose—the following information prominently on the front of the research report and, even more importantly, in all media interviews and appearances:

- Investment holdings of Wall Street analysts, their immediate families, the Wall Street firm's management and the firms themselves.
- Directorships on the subject company's board by the analyst, a member of their immediate family, or other members of the Wall Street firm.
- Compensation that was received by the Wall Street firm from the subject company and the nature of the relationship or services provided.
- Where and how to obtain information about the firm's rating system, and its policies to protect and promote independence and objectivity.
- Material gifts received by the analyst from either the subject company or the Wall Street firm's investment banking or corporate finance department.

We caution, however, that effective disclosure in media interviews and appearances will only be accomplished with the full cooperation and active support of the media itself. Neither Wall Street analysts nor their firms should be held accountable for what the media won't publish or broadcast. We call upon the media to ensure that these disclosures reach their intended audience.

We also think that rating systems need to be overhauled so that investors can better understand how ratings are determined and compare ratings across firms. Ratings must be concise, clear, and easily understood by the average investor. We would also suggest that, in addition to the recommendation itself ("buy-hold-sell" or market "outperform-neutral-underperform"), the rating should also include a risk element, to provide a measure of expected price volatility or other risks, and a time horizon, to provide an estimated time period for the stock price to reach the price target or which the analyst expects the current rating to hold. We believe that adding a risk measure and time horizon to the rating, and always communicating all three elements, will provide investors who do not read or have access to the full research report with better information by which to judge the suitability of the investment to their own unique circumstances and constraints.

Finally, under normal circumstances, Wall Street analysts and their firms should also be required to update or reconfirm their recommendations on a timely and regular basis, and more frequently in periods of high market volatility. They should be required to issue a "final" report when coverage is being discontinued and provide a reason for discontinuance. Quietly and unobtrusively discontinuing coverage or moving to a "not rated" category, for example, a "closet" sell, does not serve investors' interests.

Closing Remarks

In closing, I would like to impress upon the Committee that the AIMR and its members appreciate the seriousness of the problems facing our financial markets at

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[1] We believe that it would be interesting and informative to see the pattern of Wall Street analysts' compensation *vis-à-vis* their recommendations and *vis-à-vis* the success of their firm's investment banking activities for their industry and in total.

this time. We believe that only with the cooperation and involvement of all market participants will effective long-term solutions be developed and implemented. Specifically, we are convinced that:

- Until the Financial Accounting Standard Board and the Securities and Exchange Commission are truly free of undue external influences, and thereby able to establish and enforce financial reporting and disclosure standards that command full transparency, investors will be disadvantaged.
- Until financial reporting standards are developed for the benefit of investors, the primary *users* of financial statements, instead of for the benefit of issuers, enabling them to manipulate earnings and hide liabilities and losses, investors will be disadvantaged.
- Until auditors renounce their advocacy of corporate interests, regain their lost independence, and become vigilant watchdogs for truth and fairness in financial reporting, investors will be disadvantaged.
- Until corporate management understands and embraces the need to put their companies' long-term business targets and shareholder interests first, rather than managing earnings to maximize their own personal compensation—and publicly acknowledge their commitment to this end—investors will be disadvantaged.
- Until corporate management recognizes that good companies are not always good investments and desists in retaliating against analysts and their firms for issuing negative opinions on the company's securities, investors will be disadvantaged.
- Until Wall Street and similar firms worldwide recognize that it is in their best interest, including their financial interest, to reward high quality, independent research and require their analysts to express objective views on their assigned companies without recrimination or financial disincentives, investors will be disadvantaged.
- And finally, until all Wall Street analysts:
  —Demand quality financial reporting so that they are confident in the reasonableness and in the adequacy of the information that forms the basis for their recommendations.
  —Ferret out information *not* contained in the primary financial statements, but obscured in footnotes and other disclosure documents.
  —Embrace personally and cling tenaciously to a strict code of ethics and standards of professional conduct that require them always to place the interests of their investing clients before their own—or their firm's—investors will be disadvantaged.

Finally, I believe that if we put even a fraction of the creativity and energy into strengthening the integrity of our financial markets that has gone into undermining it—and I mean strengthening each and every one of its disparate elements that I have discussed today—we will be rewarded with renewed investor confidence in those markets, greater reliance on financial reporting information and the research and recommendations that flow from analysis of that information, and with the kind of transparency that will be a long-term benefit for investors in those markets and the envy of investors in every other financial market in the world.

Thank you. I will be happy to answer any questions that you might have.

PREPARED STATEMENT OF DAMON A. SILVERS

ASSOCIATE GENERAL COUNSEL

AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

MARCH 20, 2002

Good morning, Mr. Chairman, my name is Damon Silvers, and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL–CIO believes today's hearing on corporate governance in the aftermath of the collapse of Enron and similar events at companies like Waste Management and Global Crossing is an essential part of a much needed effort at comprehensive reform of the capital markets.

Corporate governance is a web of relationships. These relationships should work toward getting companies to make smart, long-term focused decisions that lead to sustainable benefits to all who participate in the company. Unfortunately, Enron is a window into a set of pervasive conflicts of interest that defeat the purposes of corporate governance and threaten the retirement security of America's working families. At Enron the management, the board of directors, the outside auditors,

and the Wall Street analysts all failed to protect investors. And similar events have both preceded and accompanied Enron's collapse at Global Crossing, Cendant, Waste Management, McKesson and more. The source of these failures lie in the unregulated conflicts of interest that permeate the relationships between the management of these companies and the people who were supposed to be protecting investors.

The AFL–CIO's 62 member unions and their 13 million members urge that this Committee take up the task of crafting comprehensive legislation to take on the conflicts of interest in the capital markets and in the board rooms of America's public companies. You have heard in prior hearings from those who have benefited and continue to benefit from these conflicts as to why they must be allowed to continue, from those who would lull you to sleep with the lullaby that everything will be alright if you just do nothing. That may be the view from K Street, but it is not how things look for thousands of working families in Houston and Portland, Oregon and Rochester, New York who have lost their retirement savings and in some cases their jobs and their health care because they believed what they were told—by their employers, their employers' accountants, and the analysts that interpreted the accountants' numbers.

Let me then address what a comprehensive reform package requires.

Corporate governance starts with boards of directors. Public company boards need strong independent directors who are accountable to investors. Part of the problem at Enron was that Enron touted directors as independent who really had significant ties to Enron management, ties that Enron did not have to disclose. So investors first need complete disclosure of all ties between board members, the company, and company management. Then this Committee should encourage the NASD and the New York Stock Exchange to require that this higher standard of independence be the relevant standard for measuring the independence of auditor and compensation committees.

With genuine independence from management must come genuine accountability to shareholders. Shareholders should have access to management's proxy, not just for shareholder proposals on a handful of subjects, but for director candidates that a substantial number of shareholders want to see on the board of the company they invest in. Investors also deserve the right to bring before the annual meeting through management's proxy any proposal that is legal and can be shown to enjoy significant shareholder support.

The second area in need of reform is the practice of public accounting. There are three issues here—independence, oversight, and the process by which the accounting rules are made. On independence, the simple fact is that you cannot be a public auditor with an obligation to get the numbers right for a public audience and also be a consultant whose aim is to advise executives on how to optimize the numbers. The tension between those goals is too severe and the rewards for compromising the public audit responsibility are too great. It is just too easy for an auditor seeking to blend those roles to end up like Arthur Andersen at Enron, structuring SPE's as a consultant and auditing those same structures as an auditor.

The Big 5 firms now seem to be arguing that if they cannot earn the big money as consultants they won't be able to attract top people. From an investor perspective, we would say the opposite is true—that unless audit and consulting functions are separated, the Big 5 will not be able to attract anyone with any integrity to their audit practices, and integrity is what worker funds want in an auditor.

The next issue after independence is oversight. Former SEC Chair Arthur Levitt has outlined what we believe are the key characteristics of a much needed auditor oversight body—members independent of the Big 5, full investigative and disciplinary powers, and independent funding.

Finally, there is the rulemaking process. Anyone familiar with the political pressures brought to bear on the FASB around accounting for executive stock options in the mid-1990's, not to mention the decade long paralysis on SPE accounting knows that the FASB is too open to pressures from issuers and those beholden to issuers. Here there are a variety of options available for how to make FASB more independent—ranging from merging with a public auditor oversight body to closer ties with the SEC.

Then there are the Wall Street analysts. These people play a vital role in our markets—they interpret the numbers. But analysts have become captive to the investment banking side of their firms. That is why part of a comprehensive package of reforms would be a provision banning basing analyst compensation not just on specific investment banking transactions, but also barring tying analyst compensation to investment banking performance generally.

Finally, I want to address the ultimate accountability measures available to shareholders—recourse to the courts. The AFL–CIO and worker funds view litiga-

tion as part of a continuum of tactics for holding the management of the companies we invest in accountable and for recovering money fraudently taken from us. As such, we strongly believe that the current immunity from civil suits in the law for those who aid and abet securities fraud is outrageous—and directly connected to the rise in accounting restatements and accounting fraud since the Central Bank of Denver case in 1994. We also support a number of other reforms in the area of securities litigation, such as a restoration of the doctrine of joint and several liability in private securities cases and the extension of the statute of limitations in securities cases beyond its current 3 years.

Together, these measures constitute a comprehensive approach to the problems presented by Enron and similar companies. This approach is in great measure embodied in the House bills introduced by Representatives LaFalce and Dingell. Here in the Senate Senator Leahy and Majority Leader Daschle have introduced a positive bill on litigation, as has Senators Dodd and Corzine on accountants. But there is a need for a comprehensive approach here in the Senate, one we hope this Committee will provide.

In closing, I wish to strongly emphasize the labor movement does not view what happened at Enron as the product of a few bad people at Enron or at any other company, for that matter. While those individuals who have been given the responsibility to manage workers' and the public's money need to be held to a single high standard, we believe at the heart of what happened at Enron are systemic problems that need systemic solutions. These solutions will offend powerful interests, but they will protect America's working families. The AFL–CIO welcomes the opportunity to continue to work with the Banking Committee as you take up this challenge.

Thank you.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR AKAKA FROM SARAH TESLIK

Q.1. The Committee heard recommendations that corporate board members become more actively involved to protect investors. Are current board members prepared for this increase in responsibility?

A.1. Probably some are but most are not. I do not think too many directors have seen it as their duty to protect investors. Traditionally, many of them saw their duty largely as confined to hiring, firing, "overseeing," and approving the compensation of the CEO, whose leadership they generally followed and whose decisions they pretty much rubber-stamped. Their "education" consisted of being briefed by the general counsel and corporate secretary on the statutory duties of care and loyalty, director liability, and what would go on at the annual meeting.

In the last 15 or 20 years, increased shareholder activism and media coverage on the failings of some boards have sparked improvements in corporate governance at many companies. Many of the board members now attend seminars sponsored by such organizations as the National Association of Corporate Directors, the Wharton School and Stanford University. They also receive publications such as *Directors & Boards, Directorship* and *Director's Monthly,* which contain articles advising directors on how to deal with governance issues. New venues have sprung up recently offering more intensive instruction in certain areas, such as the Delaware Audit and Financial Reporting Institute for Corporate Directors at the University of Delaware and the Directors' Summit at the University of Wisconsin. But much more is probably needed.

Q.2. If not, what can be done to better prepare board members for taking a more active role?

A.2. If the goal is to get directors more actively involved in order to protect investors, the biggest thing that is needed is a change of mindset. Directors must understand that they are elected to represent and protect the shareholders, not the management. They are there to oversee management, not maintain a cozy relationship with it. They should not only meet the most stringent definitions of independent, with no ties to management or the company, but they should think and act independently.

The shareholders—the owners of the company—would elect only directors who accept and live by these basic premises if they could, but they typically have no voice in the selection of directors. In most cases, the only way they have of holding their elected representatives accountable for governance or performance failures is to apply pressure via shareholder resolutions and other forms of activism or withhold their votes from the directors when they stand for reelection, which has no practical effect. The time may come when shareholders can have access to corporate proxy materials to nominate directors, but until then, costly proxy fights are the only avenue open to them to replace directors.

Education and appeals to the pride of incumbent boards and CEO's have resulted in some improvements, such as CEO, director, board evaluations, and the weeding out of some weak or nonperforming directors, but this is hardly sufficient to produce a whole new culture of directors dedicated to protecting investor interests.

What is needed is, first, strong, independent boards. Congress and the Securities and Exchange Commission should press the stock exchanges to adopt tough standards for determining the independence of board members and to require that a substantial majority of board members for listed companies meet those standards. The Council of Institutional Investors recommends that at least two-thirds of a board's members be independent, according to its stringent definition, and that all members of the audit, nominating, and compensation committees be independent.

In addition, to strengthen the position of the independent directors, the Council believes that if the CEO is also board chairman, there should be a lead, or contact, director for directors wishing to discuss issues or add agenda items that are not appropriately or best directed to the CEO. The board, not the CEO, should appoint its own committees and committee chairs. Boards and committees should meet in executive session on a regular basis, and should be able to hire their own experts or other service providers as needed. Directors should attend the annual shareholders' meeting and be available to answer shareholder questions; they should also respond to communications from shareholders and seek shareholder views on important governance, management, and performance matters. There is no reason for directors to be shielded from the views of the shareholders who elect them. All of these things, and more, are found in the Council's corporate governance policies, which can be accessed at *www.cii.org.*

Also essential to getting strong, independent boards dedicated to protecting investors is to have all directors stand for election every year, and to have boards evaluate themselves and their individual members on a regular basis. Board evaluation should include an assessment of whether the board has the necessary diversity of skills, backgrounds, experiences, ages, races, and genders appropriate to the company's ongoing needs. Directors with poor attendance records should not be renominated, and boards should review the performance and qualifications of any director from whom 10 percent or more of the votes cast are withheld. Directors need to understand that election to a board is not a lifetime appointment and that they will be held accountable.

The Council believes directors should receive training from independent sources on their fiduciary responsibilities and liabilities. Directors have an affirmative obligation to become and remain independently familiar with company operations; they should not rely exclusively on information provided to them by the CEO to do their jobs. Audit committee members in particular need to be financially knowledgeable and have some expertise in accounting or in financial management.

The Council also believes that the directors will protect investors' interests best if their own compensation is designed to align their interests with those of the shareholders. Directors should be compensated only in cash or stock, with the majority of compensation in common stock. Absent unusual and compelling circumstances, all directors should own a meaningful position in company stock, appropriate to their personal circumstances, in addition to any options and unvested shares granted by the company.

ACCOUNTING REFORM AND INVESTOR PROTECTION

THURSDAY, MARCH 21, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:25 a.m. in room SH–216 of the Hart Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

We were delayed, obviously, because of the vote. I hope we will be able to proceed now without any interruptions.

This morning, the Committee on Banking, Housing, and Urban Affairs conducts the tenth in a series of hearings on accounting and investor protection. We have heard from some very distinguished witnesses in the course of these 10 hearings and they have brought some valuable perspectives to the work that is ahead of us.

Today, we are very pleased to have the Chairman of the Securities and Exchange Commission, Harvey Pitt, with us. Chairman Pitt is the Commission's 26th Chairman. The SEC, of course, is known as an agency which has traditionally attracted very accomplished and dedicated professionals. It has been described by some as a jewel among Government agencies, and I think that is, by and large, deserved.

Mr. Pitt actually began his career at the SEC and was the youngest general counsel in its history. But he has enormous burdens and responsibilities at the present time, as we examine carefully the system and the structure. I think it is clear that we need to make changes. You always have human failings, but you should have a system in place that minimizes the likelihood of that either occurring or going undetected and unpunished, and provides the investor protection and the integrity of the markets which we constantly reiterate are so important to our economic success, both historically and currently, and as we project into the future.

Of course, there is a serious erosion of investor confidence right now that is very visible and, obviously, we have to take major steps to restore that.

We are very pleased to have Harvey Pitt with us. I think we will move right ahead here because we may be interrupted for further votes on the floor.

Yesterday, an objection was raised to committees meeting after 2 hours. I hope that does not happen to us today, but we will just proceed apace.

Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, thank you, the point is well taken.

We are delighted to have the Chairman here. I was saying to him earlier, does private practice look better to you now?

[Laughter.]

He has had a difficult set of circumstances to deal with. But while there may be some disagreements from time to time, I think a lot of us feel very reassured because he knows these issues very, very well.

As the Chairman pointed out, you began your career at the SEC and have been engaged in a strong private practice involving the securities area for a good part of your adult life. You bring a good deal of information to this whole debate.

For the record, I wanted to say again what all of us have said here. This is the tenth hearing this Committee has held on this subject matter. By my calculation, Mr. Chairman, you have had 38 witnesses from both the public and private sectors before all of us here who have been interested in this.

These witnesses include five former chairmen of the SEC, the chairman of the International Accounting Standards Board, as well as the chairman of its trustees, a panel of SEC chief accountants, a former chairman of the Financial Accounting Standards Board, the CEO of a preeminent pension fund, authorities on corporate governance, preeminent securities law professors, members of commissions that study accounting reforms, Comptroller General of the United States, the CEO of securities self-regulatory organization, leaders in the accounting industry, institutional investors, scholars, consumers, labor and investment practitioners, and educators.

Whatever else one may think, this has been a very comprehensive examination of this issue, and this in my view, Mr. Chairman, is how the Senate of the United States ought to operate. And it is a tribute to the Chairman's leadership of this Committee that we have examined this issue about as thoroughly as you could do in extensive hearings.

So it is very appropriate and proper that we conclude with you, Chairman Pitt, to hear your views on the subject matter, and I am anxious that we get to it.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman, for holding this very important hearing. And I would like to thank Chairman Pitt for testifying today.

As you all know, a number of committees on both sides of the House and Senate have had many hearings on this issue. While some of these committees' hearings have been very partisan and will not go down as the finest hearings in the history of the Senate or the House, I would like to commend you, Mr. Chairman, for your

leadership in making sure that these hearings did not end up like that. Your hearings have been focused on how to ensure that the Global Crossing, Andersen, and Enron messes never happen again, not trying to score political points. You have done a very good job.

Chairman Pitt, it was not so long ago that you were in New York choosing what securities cases you wanted to take. Would you like to go back?

[Laughter.]

Chairman PITT. No.

[Laughter.]

Senator BUNNING. Now, after taking a pay cut, you are in the middle of this debacle, coming on the heels of September 11, when you had to work very hard just to make sure that you could open the markets. I am starting to wonder if you are jinxed.

[Laughter.]

All kidding aside, I know that there were calls for you to recuse yourself from the Enron matter, but so far, the SEC has acted swiftly and decisively to fix the problems that have arisen. But obviously, there is much more to do and I look forward to working with you.

Personally, I think that the two areas we must concentrate on are auditor independence and analysis issues. I was one of those who urged your predecessor to slow down a little on the auditor independence issue. I thought he was trying to ram a major rule through and taking side in an industry fight without the proper vetting.

Though I still think that we were moving just a little too fast at the time, I think that we must have a true auditor independence. Although the firms have split off their consulting arms, we should codify that split into law. If you audit someone, you should not be able to do their business consulting.

I am also very concerned about the Chinese walls between analysts and their firms. In another committee, we had some analysts from three major credit-rating agencies. It is still beyond me that despite all the information they are supposed to have that the public does not get to see, that they did not lower Enron's credit rating until 4 days—4 days—before it filed for bankruptcy.

I spent 25 years in the securities business. We had Chinese walls at the firms that I worked at. But believe me, I and the rest of the people that worked in that firm knew what was going on.

We must make sure analysts protect the investor they are advising, not the position of the firms they represent. I am happy to see that you are going to hold an inquiry into the SEC's regulation of the credit-rating agencies.

Chairman Pitt, once again, I want to thank you for testifying today. I look forward to hearing from you.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much.

Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. Let me echo the comments of my colleagues that I think you have run an out-

standing series of hearings that I think you could almost categorize as a seminar on the issues of financial reporting and accounting.

I am not sure any of us will get passing grades, but we are going to try when we get around to dealing with suggestions on reform.

I truly appreciate it. It has been enlightening. I have learned a lot and it has been very helpful. I thank Senator Dodd for his help with trying to start working on those final papers that we are putting forward with regard to some of these issues.

I think there is much to be derived from these hearings in trying to make sure we come up with a balanced and sensible approach, one that doesn't overreach, but builds the investor confidence that I think we need to have strong working, functional capital markets.

I also want to say thank you to our witness, Chairman Pitt, for his service. I hope that sometimes when disagreements occur, it is not in any way interpreted as anything other than the challenges that one has with intellectual arguments about how we best get to an end goal that I think we all agree on.

Your intellect and integrity, in my mind, is unquestioned. The efforts of the SEC and its response, particularly through enforcement activities, I think has been strong and one that is of due process. And I congratulate both you and the SEC for those efforts.

I hope that we can all certainly win on one issue together in a very bipartisan manner, making sure you have the resources that allow the SEC to do the job that it needs.

I know this is important to the Chairman and to all of us on the Committee, to make sure the SEC, which provides oversight to a $10 trillion economy, is not going to war with BB guns and slingshots in a world that is extraordinarily complicated today.

So, I look forward to the Chairman's comments and moving on to some of the work on the final papers.

Chairman SARBANES. Thank you very much, Senator Corzine.

Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman, and thanks again for holding another in this series of hearings that is helping to educate all of us on a number of situations, particularly accounting.

Chairman SARBANES. We have brought joy to Senator Enzi's life.

[Laughter.]

He is the only accountant in the Senate. Maybe in the Congress. I am not sure.

Senator ENZI. No, there are five in the House. So there is kind of a limit of one of us per hundred.

[Laughter.]

Senator GRAMM. You don't want to enliven the party too much.

[Laughter.]

Senator ENZI. This is the next best thing to March Madness.

[Laughter.]

I am very much looking forward to hearing Chairman Pitt's comments. I know this is another appearance before us and I want to thank him for the meetings and the phone calls that he has also had with me, and in addition, the participation of your head accountant, Mr. Herdman.

It has been very helpful in giving me a better understanding of what is going on, and I cannot think of many other chairmen of agencies who have had the workload that you have had and the issues of importance placed on them in such a short timeframe.

I think you have performed remarkably well and I want to commend you for that.

Mr. Chairman, what has happened to the confidence in our markets and in our financial reporting system is alarming. Without the confidence of the individual investor, our markets cannot work. The small investors have the important role of providing needed liquidity in our markets and allowing companies to raise the capital required to grow the economy and increase the number of jobs in our country.

The characteristics inherent in our capital formation process are why we are the envy of the world. We are considered to be the best at what we do. Recently, probably partly because of the efforts of Congress, a little bit of the gleam has been taken off, but, hopefully, we can restore that without damaging the system we have.

I am encouraged to see that there is a new focus on the role of accountants. I am really very excited about this. I am told that in classrooms across the country, kids are saying, what is this accounting stuff that is so powerful that it destroys companies like Enron?

Now that they see it as a really sexy profession again, there are a lot more inquiries and a lot more people going into it.

But mostly what it is, is an opportunity for the companies themselves to get people across the country to understand what auditing is. Normally that is kind of a glaze-the-eyes-over situation.

The only way we have been able to get around that is to throw in this consulting thing because consulting has more appeal than auditing. I think a lot of people think of auditing as storm troopers from the IRS descending on your home to check your taxes, doing it in a few minutes, assessing some penalties and leaving. Instead of the very lengthy and detailed process that accountants actually have to go through, particularly when they are exploring a company as big as Enron or any other of the big companies, or even some of the smaller ones that file with you.

I do have a lot of small businessmen across the country who are contacting me and saying, please do not make us pay for two audits. When I ask what they are saying, they say, well, the auditor goes through all of my books and everything and he sits down with me and I say, what did we do wrong? He tells me. Then I say, what should we do better? He says, whoa, that is consulting. You will have to hire somebody else, to look through the same set of books, pay them the same money, but I just do not want any liability at this point for answering those questions.

It has been a traditional role that accountants have played. In the bigger companies, if we draw the lines too closely, then we have the problem of them not being able to get the kind of expertise they need to be able to understand the company that they are auditing.

I do appreciate all your patience and the way that you have looked at this and would love to know how some of the investigations are going, but know that that is not territory that we can get into yet, although it is probably territory that we ought to look at

before we make massive decisions on behalf of the very successful business community across the country.

I do hope that we will be careful when crafting legislation. What has happened with Enron is a terrible thing. We cannot overreact with legislation as a response to Enron, particularly before we know some of the details on what happened with Enron and Global Crossing and the other companies that have come to light recently.

It is important to remember that what happened at Enron was, in all likelihood, already illegal and the persons responsible I trust will be punished. But what we are going to do will have far-reaching ramifications.

So, I do urge all Members to take the time to completely understand the impact of the actions and I thank you for being willing to testify here today and I thank the Chairman for making all of this possible. I look forward to working on the issue.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much, Senator Enzi.

Senator Gramm.

STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Well, Mr. Chairman, first of all, every time we have one of these hearings, I say something good about you. I know that at some point in this process, when something bad needs to be said, that you are going to remind me of all the good that I have said. So, I want to be careful.

But I do want to say that I have been proud of this Committee on many occasions. And I am very grateful that the most important decisions we are going to make in the wake of the problems that we have had in the last year will be made in this Committee.

I think that the Congress and the country will be blessed by that being the case.

First of all, we know more about these issues than anybody else because we deal with them all the time. Second, we have a lot of people who want to do something on a bipartisan basis. It is very important that we try to achieve that because if we do, I think that our product will stand the test of going to the floor and will ultimately become law.

I would like to also say that I am very proud of how you have conducted these hearings on a forward-looking basis. So much of what has been done in Congress has been finger-pointing for the media, which I think has not reflected glory on the Congress.

I think everything you have done forward-looking about what is the problem and how can we fix it and what contribution can we make, I think that is what, at least when we were schoolboys, we read about in these textbooks that Congress was supposed to do.

So, I want to congratulate you.

I am very glad to be here with the Chairman of the SEC, Harvey Pitt. I cannot imagine anybody with a better background to deal with these problems than Harvey Pitt.

I know there are some people who think that, well, if you have had association with accounting firms, whether you brought actions against them at the SEC or whether you have defended them, and Harvey Pitt has done both, that somehow, you are corrupted.

In fact, as some of you know, I have a son who is a rock star. He took Latin and Greek in college, so he has no production skills.

[Laughter.]

After much prayer and help from God, he is now in business school. So, as he was off to business school in New York, the first course he had to take was in accounting. He said, "Pop, what exactly is accounting?" And I did not realize it at the time, but he is qualified to be on this accounting standards board because, obviously, he knows nothing and therefore, he cannot be corrupted.

[Laughter.]

I have a very strong feeling about experience and knowledge. I do not believe in guilt by association. And I think that your broad experience and your knowledge and understanding is a great asset.

I would like to say, Mr. Chairman, that we are going to give you the tools you need. I do not believe we are going to write accounting standards in this Committee. I hope we do not in the Congress.

Ultimately, you are going to be the person that puts the program into effect. And I would just like to say that, given your background, given your experience, and given your proven integrity in everything you have done, I could not be more confident in anybody than I am you. I think we are very blessed to have somebody with your background at the SEC at exactly this moment.

Finally, clearly, I saw a front page *Business Week* article about you—I have always thought of *Business Week* as being a corporate socialist magazine. I hope they are listening.

[Laughter.]

I hope you will exercise your good judgment and your experience. And you are not standing for election anywhere. It is very important, given the parameters of the law, that you exercise positive judgments in looking at benefits and costs and that you do what is right. I have confidence you will. So, I want to thank you and I am glad you are here today.

Chairman PITT. Thank you.

Chairman SARBANES. We want you to do what is right without any reluctance, if I can refer back to the article that Senator Gramm talked about.

Chairman Pitt, we are pleased to have you here. We would be happy to hear from you.

STATEMENT OF HARVEY L. PITT CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman PITT. Thank you, Mr. Chairman, Senator Gramm, and Members of the Committee.

I am pleased to appear here on behalf of the Securities and Exchange Commission. Before I discuss some of the critical issues before this Committee, I do want to take a second to thank each of you for the kind words and for your support.

Senator Bunning, I do want to assure you that I think I have the greatest job in this country, and I am not interested in returning to private practice, either now or potentially, ever. This is a great job. Not that I will stay here forever, but this is a wonderful job and I wouldn't change it for anything right now.

Chairman SARBANES. Actually, you are not even yet into the 5 year term. You are still doing the excess over the 5 year term, if I am correct.

Chairman PITT. Yes, that is correct. I did take a 99 percent pay cut, however.

[Laughter.]

I have followed with enormous interest and admiration the issues this Committee has explored the past 2 months. I commend the thoughtful and deliberative approach the Committee has taken under Chairman Sarbanes' leadership. In the face of crises and their concomitant turmoil, it takes patience and restraint to develop a full legislative record.

Chairman Sarbanes, I congratulate you on this approach. I also want to thank you, Mr. Chairman, as well as Senator Gramm and the Full Committee, for the strong bipartisan support that this Committee has expressed for funding pay parity and our need for additional resources.

My tenure at the SEC is still relatively brief, although some days, it seems as if I have been here much longer.

Three crises occurring at the outset of my tenure—September 11, Enron's bankruptcy, and last week's indictment of Arthur Andersen—focused national attention on the need for meaningful reforms of the laws and rules we administer.

Both Congress and the Commission must act: The Commission, through regulation and enforcement, which has the benefit of immediacy and flexibility; and the Congress, through legislation, which has the advantage of extending our reach and authority where appropriate.

We cannot act independently of one another. We must act in concert if we are to restore public confidence in our markets and make the world's best capital markets even better. You have my commitment that we will continue to do precisely that.

At my confirmation hearing, Senator Dodd gave me some sage advice. He said: "Your job is not to become the most popular guy in town. It is to be the guy that actually will look at us and tell us, no matter how unpopular it may be, that you have an obligation to do what is really right on behalf of investors in this country."

I am positive I have satisfied the first prong of Senator Dodd's advice. I am not the most popular guy in town. Today, I hope to satisfy the second prong of Senator Dodd's counsel. I will tell you in unvarnished tones what we think must be done to restore public confidence and to repair the critical aspects of our system that have remained broken for far too many years.

In response to recent events, I believe that we need to address three overarching reform needs.

First, disclosure by public companies must be truly informative and timely. Of course, it has to be honest.

Second, oversight of accountants and the accounting profession must be strengthened and the accounting principles that underlie financial disclosures must be made more relevant and more comprehensible.

Third, the governance of American companies must be upgraded.

We have already taken or announced a large number of significant initiatives.

In cautionary advice issued on December 4 of last year, we provided guidance on the appropriate use of and limits on pro forma financials and we followed that with an enforcement action to back up our statements.

We issued further cautionary advice on December 12, setting forth the initial requirements and guidance on the obligations of public companies to disclose critical accounting principles.

On December 21, we announced our staff would monitor annual reports submitted by all Fortune 500 companies in 2002. This initiative significantly refocuses and improves our review program for financial and nonfinancial disclosures by public companies.

On January 17, we announced our preliminary—and I stress preliminary—concept for a new private-sector regulatory body to oversee the accounting profession.

On January 22, we identified issues in management's discussion and analysis to be addressed in 2001 fiscal year-end reports regarding off balance sheet financing arrangements.

On February 4, the securities industry and its self-regulators, acting with our guidance, announced proposed rules to create more transparency for analyst recommendations.

On February 13, we announced proposals to address aspects of corporate disclosure needing immediate improvement. Also on February 13, we called upon the New York Stock Exchange and the Nasdaq to look at specific components of corporate governance, and they have responded remarkably.

This past Monday, we released orders and temporary rules in order to assure a continuing and orderly flow of information to investors and the U.S. capital markets in light of Arthur Andersen's indictment.

On Tuesday of this week, the Commission commenced a formal, quasi-legislative investigation into the activities and effects of rating agencies on our capital markets.

On March 13, we brought an action against the former CEO of a public company seeking to recoup bonuses, options, and salaries paid for financial performance that was a sham. This was a landmark effort by the Commission's Enforcement Division.

Before turning to the three-pronged approach we believe that you and we should take together, I want to add a word about the need for legislation and additional regulation.

I have said many times already that I do not believe that new legislation or new regulations are the key to solving every problem. I do believe, however, that we must respond to a unique crisis of confidence created in our capital markets and I want to assist this Committee in developing a sound legislative proposal and to work with you to tailor our concepts of necessary regulations.

In short, I support your efforts, Mr. Chairman, and those of the Committee to take prompt and appropriate steps. Whether or not we always agree on the solutions, this Commission will always agree to assist you in achieving your objectives and implementing your legislative directives.

We have begun enhancing our corporate disclosure system. The reforms we contemplate are aimed at improving the quality and

timeliness of financial disclosure. The Management's Discussion and Analysis (MD&A) Section of disclosure documents is meant to be for investors a narrative explanation of, and provide the context for, companies' financial statements, so that investors can see the companies in which they invest through the eyes of management and understand the risks to a company's earnings and cashflow. MD&A is the cornerstone of our system of corporate disclosure and it must be improved.

The rule reforms to Management's Discussion and Analysis that we contemplate include: Codifying principles that we suggested companies adopt voluntarily in December to identify their most critical accounting policies; mandating specific disclosures concerning relationships with entities that have a great impact on a company's financial condition, such as off balance sheet financing arrangements; and improving disclosures relating to key trend information without converting our disclosure system into an attractive nuisance for increased litigation.

In addition to these planned MD&A disclosure reforms, we have in mind two very different initiatives, both of which are still in the conceptual stage, to improve the quality and utility of our corporate disclosure system.

First, we believe investors would benefit if companies produce clear and concise financial statements that allow readers to explore whatever layer of detail they wish. This would not be an initiative to "dumb-down" financial statements, but an effort to give companies the flexibility to produce and to disclose financial information in layers.

Second, we can improve the corporate disclosure system by increasing the CEO's individual accountability for his or for her company's disclosure. We intend to implement the President's directive to us to require CEO's to certify their company's annual and quarterly filings in a meaningful way. We are also considering rulemaking to require corporations to adopt procedures designed to bring important information to the CEO's attention.

Third, we intend to impose obligations on companies to report immediately any transactions by corporate insiders, including transactions with the company. This would quickly address an issue that is circumscribed by existing statutes and rules. Corporate insiders need not file reports of their activities in their company's stock for as long as 40 days after the transaction. And a few years ago, the Commission adopted a rule that permits insiders to delay filing trading reports for up to a year if, as in Enron's case, the trades are directly with the company. While we seek to require faster and better disclosure by rule, a legislative solution here would be very helpful.

Fourth, we intend to expand significantly the list of items to be disclosed by companies between their quarterly and annual reports. At present, only five events require intra-period disclosure. We propose to add about a dozen new significant events to that list. Over the longer term, we also will implement amendments to the basic framework of the reporting system to require public companies to disclose vital information on a current basis. Our present laws only provide investors with a still life picture of a company. We want to provide them with a moving picture.

We also believe there are a number of ways that corporate governance standards can be improved to strengthen the resolve of honest managers which may have eroded in recent years, due in part to the increasing pressures to meet elevated expectations. We do not, however, contemplate changing the basic division of labors between State governments which regulate corporate behavior and the Federal Government, which regulates securities transactions.

To this end, last month we asked the NYSE and the Nasdaq to review their listing standards on a number of important issues, including officer and director qualifications, continuing legal education, and codes of conduct for public companies. And we separately asked Financial Executives International to review its code of ethics in light of recent developments. The private sector and the self-regulatory bodies have been responding in a way that is quite gratifying.

Perhaps the most pressing need is the reform of our accounting system. We see the need for reform in two areas—the regulation of accountants who audit financial statements of public companies and regulated entities, and the process of setting substantive accounting standards.

The number of sudden and dramatic reversals of public companies' financial conditions calls into question the regulatory system currently used to oversee the quality of the audits of public company financial statements.

Therefore, we propose a new private-sector regulatory body, the Public Accountability Board, to direct periodic reviews of accounting firms' quality controls for their accounting and auditing practice, as well as discipline auditors for incompetent and unethical behavior. This PAB would replace the system of self-regulation, to which the accounting profession is currently subject, such as the current system of firm-on-firm peer reviews overseen by the POB, under the aegis of the AICPA.

There is substantial consensus on this point. Indeed, the AICPA and the major accounting firms have embraced the need for this change to restore public confidence. The PAB would supplement our own enforcement efforts by adding a tier of ethical and competence requirements beyond legal prohibitions and requirements.

Such two-tier regulation has been successful in the securities industry. While the SEC is well suited to bring actions for fraud and such, private regulation can govern conduct that may not be unlawful, but that should be deemed unethical or incompetent.

We believe the PAB should be comprised predominantly of members currently unaffiliated with the accounting profession. But we do, however, believe that the public will benefit if the PAB includes some members, a minority, from the accounting profession who would bring necessary expertise to the process.

To assure the quality and independence of the members, the selection of the initial group of PAB members should be made by the Securities and Exchange Commission and future selections subject to SEC approval.

In addition to independent membership, we believe the PAB should have a secure and independent funding source. We propose a system of involuntary fees to be imposed on all who benefit from financial audits, including, but not limited to, the accounting pro-

fession. It is also important that we take steps to ensure that auditors are perceived as being, independent of their audit clients.

The Commission adopted rules on auditor independence less than 18 months ago, after considerable study and discussion. A number of those rules have not even become effective yet. The Commission's new requirements provide a framework to be applied to any proposed nonaudit service to determine whether it is inconsistent with independence. We believe this is the correct approach.

Therefore, we believe these rules should be tested, but reformed if problems are shown to exist.

It is useful to recall in this context that there were large audit failures long before accounting firms had any significant consulting business. Merely mandating the separation of consulting from auditing to create an audit-only firm, as some have suggested, does not guarantee an audit failure-free future.

For one thing, an audit-only firm also would be more dependent, not less, on their audit clients, and a single large audit client could exert far more influence on such a firm than is the case with firms that have multiple sources of revenues. Moreover, information that can be gained through consulting engagements often is useful in performing audits.

Auditor independence is a complex subject. It cannot be resolved by simplistic solutions. We are opposed to those who say that accounting firms as a whole should be restricted to providing only audit services. That is not the same as saying they should be able to provide both auditing and consulting services for the same client. But even there, we urge you to decline to adopt legislation that forecloses our flexibility.

Auditor independence is a dual-faceted problem. But most importantly, those who perform the actual audits must be completely free of any pressures to waiver from absolute and meticulous application of accounting principles. When engagement partners are given additional compensation for cross-selling consulting services to the same client, they are exposed to the potential of divided loyalties. We believe those practices need to be banned.

At the firm level, the critical goal should be to both require and incentivize firms to supervise and oversee the audit team to make sure they perform audits not solely within the letter of auditing principles, but at the highest level of integrity. One of the best ways to do this is to have a vigorous auditing quality control review process, something the PAB could do. Each major firm should be reviewed by the PAB every year, not every 3 years as the POB does it, and be at risk to lose valued clients if their audits aren't deemed to be of top quality, whether or not they comply with minimal standards.

While we have statutory authority to establish accounting standards for public companies, for over 60 years we have looked to the private sector to provide the initiative in establishing accounting principles. We continue to support private-sector standard setting.

But the SEC has historically abdicated far too much of its obligation to ensure that accounting standards meet the objectives of the Federal securities laws. Consequently, we plan to take a more active role to ensure that standards are implemented that benefit markets and investors.

Going forward, we plan to use our existing authority to oversee the standard setting process to ensure that it functions in the best interest of investors by broadening funding sources and making the funding fees involuntary, meaningfully participating in the selection of the members of the FASB and setting the FASB's agenda, exercising our authority to review standards actually adopted, and ensuring that the FASB promulgates principle-based standards which adopt faster to changing business environment and emphasize overall accuracy and completeness.

There are additional areas where we need the assistance of Congress to implement our initiatives and to take other important steps in improving the integrity, quality, and timeliness of the corporate disclosure system.

The present securities laws authorize us to petition a court if we want to bar officers and directors who break our laws. We could use this tool more effectively and protect investors far more efficiently if we could impose this sanction administratively.

This would be akin to our authority to bar individuals from the brokerage industry and also akin to the authority of the banking regulators to bar future service by banking officers and directors.

A related tool is statutory flexibility to seek civil contempt penalties for those who violate prior judicial or administrative sanctions and restrictions. We now have to ask the Department of Justice to pursue those cases for us. Also, under existing law, penalties are capped at $120,000, or the gross amount of pecuniary gain for each violation, even for fraudulent disclosure violations.

We would like to increase this amount so it is a more meaningful deterrent and we also would like the authority to impose penalties directly rather than seeking them through the courts.

The last area I wanted to address briefly is the Private Securities Litigation Reform Act (PSLRA) of 1995. Some have urged its repeal. We think it appropriate to express the Commission's position. Private litigation, when properly formulated, is a very necessary supplement to the SEC's mission. The data to date, however, demonstrates no erosion of investor rights in the PSLRA's wake. We strongly urge you to refrain from making any changes in that legislation in the absence of compelling empirical support.

We look forward to continuing to work with you to make sure that we discharge our obligations prudently, generously, and in the spirit with which the Federal securities laws were adopted—to protect investors and maintain the integrity of the securities markets.

I thank you for the opportunity to testify today. I ask that my written testimony, which, unbelievably, is even longer than my oral statement, be made a part of the record, and I am pleased to attempt to respond to any questions the Committee may have.

Chairman SARBANES. Thank you very much, Chairman Pitt. The full statement will be included in the record and we appreciate the obvious time and effort that went into its preparation.

Let me start right off. There is a headline in the morning paper on the basis of your testimony yesterday on the House side that says: "Ease Up On Accounting Curbs, Pitt Says." So now what accounting curbs are there that you think should be eased up on, because most of the testimony we have been hearing has been sug-

gesting that we ought to have additional curbs of one sort or another. They vary in the extent.

Chairman PITT. I think even the reporters who write stories for various newspapers will tell you that they have no control over the headlines. But any resemblance between that headline and what I testified to yesterday is purely coincidental.

I do not believe that accounting principles or curbs should be eased up. What I do believe, Mr. Chairman, is consistent with the approach you have taken, that we should progress in a measured, thoughtful way, that to the extent that we believe there are conflicts created by firms providing more than one service to a firm, we should have the power to outlaw those, to ban them.

But to write in stone the notion that no one can provide, say, both accounting and consulting services in a firm, or even to say no consulting services can be provided to any audit client, would put us back in a situation that this Congress faced just a few years ago with the Glass–Steagall Act. It was adopted in 1933 and it took nearly 70 years to undo some of the iron-clad restrictions in that legislation.

All I am saying is that we hope that you will proceed with a flexible approach, not one that assumes an absolute position on these services.

Chairman SARBANES. Let me try to parse that out because I need to get the benefit of where you draw the lines. Do you think an accounting firm should be able to provide consulting services to an audit client?

Chairman PITT. It depends on what the definition of consulting services is.

Chairman SARBANES. Okay. If I can just pursue it.

Chairman PITT. Sure.

Chairman SARBANES. In other words, you entertain the notion that there should be some consulting services that an accounting firm should not provide to an audit client.

Chairman PITT. Absolutely.

Chairman SARBANES. In fact, the big accounting firms have themselves now, as I understand it, identified at least two such services. Is that correct?

Chairman PITT. They have.

Chairman SARBANES. Internal audit, and I think IT work. Is that correct?

Chairman PITT. Yes. But I think they have gone further. Most of them are now just severing all consulting work from their operations. That is a matter of choice. But I think they do not believe they have any choice.

Chairman SARBANES. Now, you say in your statement that the Commission has now put in a framework applied to any proposed nonaudit service to determine whether it is inconsistent with independence. And you note that Arthur Levitt, the former Chairman, endorsed the existing rules as they had been revised.

I think it is important to note, because we had Levitt before us, and he said:

> Two years ago, the SEC proposed significant limits on the types of consulting work an accounting firm could perform for an audit client. An extraordinary amount of political pressure was brought to bear on the Commission. We ended up with the best possible solution given the realities of the time. I would now urge, at a min-

imum, that we go back and reconsider some of the limits originally proposed. While I commend the firms for voluntarily agreeing not to engage in certain services, such as IT work and internal audit outsourcing, I am disappointed the firms have remained silent about consulting on tax shelters or transactions, such as the kinds of special purpose entities that Enron engaged in. This type of management consulting only serves to help management get around the rules.

So that is his current posture.

Chairman PITT. At the time that the changes in the rules were adopted, and I think we have attached the quotes for the record, he said that the rules that he was announcing were better than an absolute ban. And that was his precise word—"better" than an absolute ban.

He has a perfect right to change his position. My difficulty is that some of the things that were put in at that time have not even gone into effect yet.

All I am saying is that before we write in legislation in a way that curtails our ability to be flexible, I urge that this Committee write with a much more flexible stroke. That is my only point.

I do believe that there are potential conflicts, as I have said, but I do not believe, for example, that doing tax work where you are trying to figure out what the consequences are of certain transactions, is necessarily detrimental, particularly if the firms would lose their tax competence if they had to sever all of those tax efforts. Those are the types of things that I would like us together to have the flexibility to deal with.

Chairman SARBANES. Well, my recollection of his testimony, and I see my time has expired, was that he did not take that position on the tax work and in fact, left that open, at least certain important aspects of it, to be engaged in.

I think it is very important that we focus very directly on these different questions because you may not be out to ban all consulting services, but you may make the judgment that there are certain services that just ought not to be done.

We had the Superior Bank failure—that is not under your jurisdiction. And the accounting firm that did the audit was the accounting firm that structured the process by which the residual interests would be valued.

So then they set up this process for the valuation of the residual interests and then they came along as the auditor and of course they accepted the valuation of the residual interests that had emerged from their process.

One wouldn't expect anything less, presumably. But of course, that was the whole genesis of the ultimate collapse of that banking institution and a hit to the fund which we now estimate is—well, we are not sure—probably $350 to $400 million.

Chairman PITT. I am with you 100 percent on the notion that providing auditing and consulting services for the same client can, and in a number of situations, clearly does, create conflicts that we ought to eliminate.

What I am saying is that, as I think former Chairman Levitt's testimony here and his statements to the press when he adopted the rules show, people change their minds.

At the time the Commission adopted those rules, I received a call from Chairman Levitt asking me to talk to Members of Congress to urge them not to draft legislation establishing what the rules

would be. And that is all I am saying today I believe the case should be. I think you should tell us what standards you want us to adhere to, but trust us to have the flexibility to understand whether a particular service helps or hurts.

Chairman SARBANES. Fine. I am going to yield. Let me just be clear. We are talking here about public companies, as I discuss this issue, because that is where the investor protection issue comes in.

Chairman PITT. And regulated entities.

Chairman SARBANES. Yes. So that the nonpublic company—none of the limitations we are talking about would apply in that circumstance.

Chairman PITT. They wouldn't, sir, but the problem you would have is that you could not hire anyone competent if they could not provide services for certain types of firms. That doesn't get to the question of whether they should be allowed to perform these services for their audit clients. But unless you have a scope of practice that is broad-ranging, the best people will go some place else.

Chairman SARBANES. I just want to address the cascading-down argument that we are hearing that says, I am a small accounting firm in a small town and I represent small businesses, none of which are publicly listed. They view this with some sense of horror because they think, what is going to happen with respect to the publicly-listed companies is going to reach them.

Now the counter to the cascading-down is you get a deterioration to the lowest denominator. Obviously, it is clear all companies and those who audit them, once they list, have different responsibilities because you are drawing in the public markets and the investors.

So it is a different arena in which we are dealing. Because we heard from the accountants and they are concerned about that and I can understand they would be concerned about that. I think most of us are sensitive to that concern, but I think it can be dealt with.

Well, I have gone beyond my time here.

Senator GRAMM. Mr. Chairman——

Senator BUNNING. I yield to the Ranking Member.

Chairman SARBANES. All right. Senator Gramm.

Senator GRAMM. Mr. Chairman, I think you put your finger on a very important part of what we have to deal with. I think it is important to note that not every public company is listed on the New York Stock Exchange, that in most little towns, a lot of the companies are public and they have over-the-counter traded stock.

Chairman SARBANES. On the Nasdaq.

Senator GRAMM. On the Nasdaq or just simply locally traded.

I am just saying it is important to define what is a public company, and as I would define it, it is any company where you have stock that is owned by a group of people and you have a set of corporate governance. And I am just saying that that would not be uncommon for a fairly good-size local plumbing operation.

Chairman PITT. Your point, Senator, is more articulately made than what I was trying to say to Chairman Sarbanes. I believe that if you have a one-size-fits-all rule, you can stifle competition, you can hurt smaller companies. Even small public companies may need different treatment.

I am not prepared to say today that that is necessarily the right thing. I am prepared to say that we should have the flexibility to

tailor whatever standards are raised based on further information in light of different circumstances.

Senator GRAMM. Well, let me go with my questions and my point.

I guess I have two concerns about just mandating that if you are in the audit business, you are only in the audit business. The one is that you mentioned, and that is the isolation from expertise in areas that are critical to auditing. I think the art of this thing is deciding what areas provide the expertise and attract the real talent into accounting we want, and that minimize a conflict.

Conflict of interest exists, and there is no way it can be eliminated. You are being paid by the company, for one thing.

Chairman PITT. Exactly.

Senator GRAMM. The question is finding that point at which you haven't narrowed down the knowledge of the auditor so much that they really have to rely on the company for so much information that they are doing a nominal audit rather than a real look at the company. So that is what I would call the isolation problem.

The second problem has to do with a smaller company that cannot hire two accountants, where you have the practical problem. And many of those companies are public in the sense that they have over-the-counter traded stock, not necessarily on Nasdaq, but that might just be traded locally in Maya, Texas, and over some regional exchange.

I want to thank you for the comment about security litigation. I would have to say that I think that bill was a very important contribution. There was a real abuse. I think we took important steps to close that loophole. I know there are a lot of people who would like to open it up again and that would like to take advantage of the situation we are in. But is it not true that more money has gone to people who filed lawsuits since that litigation reform than was going to them before?

Chairman PITT. The statistics I have seen are that there has been no diminution in the number of actual class actions filed, but the settlement levels have increased remarkably since the legislation has been in effect. That could well be attributed to the notion that there are better suits being brought now, so they get higher settlements.

Senator GRAMM. Let me touch real quickly before my clock runs out on a couple of other things.

I am a little bit concerned about nonaccountant majorities on these oversight boards. And I sense maybe my view is a minority view, which is not uncommon. But it seems to me that there are two functions here. One is discipline and the other is setting standards. And maybe one of the ways we can bring people together is on the overall board that disciplines accounting and that we might give some strengthened ability to gather information and to make judgments. Maybe on that you would want a majority of nonaccountants. But where you are setting accounting standards, I think you clearly want a great preponderance of people who are accountants.

I am wondering what you would think of trying to separate those two things out.

Chairman PITT. Senator, in our written statement, we make the observation that discipline or quality control judgments have to be made by a group that has no incentive to pull their punches.

Senator GRAMM. I agree with you.

Chairman PITT. I think that is consistent with what you are suggesting. All of the members should have been in or be very familiar with the accounting profession. The only issue is, do you have anyone who is in practice now?

My view is, and I have seen this, the difference—some of my best friends are academics in law school. I like academics. But they do not have the same perspective that somebody who is out in the field every single day obtains by seeing problems in their theory. That is why you get a rule like Regulation FD, which has a great fundamental premise, but reflected a rule that was created by people who had no practical experience applying it.

Chairman SARBANES. But two issues are getting mixed up here. You can have expertise on the board because people have been trained as accountants and worked as accountants, but are not now practicing accountants, which of course raises then the difficult conflict problem.

Chairman PITT. Right.

Chairman SARBANES. We did not allow you to continue to be a lawyer doing SEC practice when you became Chairman of the SEC.

Chairman PITT. That is correct.

Chairman SARBANES. So the question becomes, as we deal with this board that is obviously coming along, how do we structure it?

Now, I think it is a reasonable point to say, well, you cannot put people on there who do not know anything. And especially in complicated matters like this. But on the other hand, the notion that you are going to take people that are right in the industry, who will continue to be in the industry, and put them on the board to do these functions, I find——

Senator GRAMM. I think once you are on the board, you are on the board.

I see it as two different functions of the board, one discipline and the other setting accounting standards.

Can I just ask one short question now?

Chairman SARBANES. Sure.

Senator GRAMM. Another concern I have, and maybe I am the only person concerned about it, but I am a little nervous—I understand a dedicated funding source and I think that is important because the power to fund and not fund is the power to influence. And I do not want influence coming directly from Congress, not that Members of Congress—I had no objection to people standing up and saying they disagreed with Arthur Levitt. What I objected to was when there was a suggestion that we were going to legislate to override what he did.

Chairman PITT. Exactly.

Senator GRAMM. That I was opposed to. But I am nervous about having this dedicated funding source and making these people so insulated from their own profession and from the whole world around them. Do you have any thoughts as to how we could do the dedicated funding source, but yet, not put these people in a position where they never have to meet with anybody, never have to listen

to anybody, and there is no vehicle whereby anybody can get their attention? That kind of makes me nervous.

Chairman PITT. Let me start by saying that the critical nature of having a dedicated funding source would deal with some of the problems that the POB experienced over time, which is somebody comes in and says, if I am doing this voluntarily and I do not like what you are doing, I am taking my money and my marbles and I am going home. That is unacceptable to us. That is one of the reasons why we felt the POB was incorrectly structured and why we felt we had to move beyond that.

You have to have what I call involuntary, you call dedicated—we are talking about the same thing. That doesn't mean that these boards should be insulated. The real problem has been, in my view, that in the past, the SEC has not been sufficiently involved in overseeing the activities of these private-sector bodies.

Again, let me just say, and I have told this to the FASB in private meetings, I have said, as long as whatever rule that you come up with does not hurt investors and is not absolutely bizarre, even though we may not like it, we will support your decision and we will not try to get you to undo a decision you have made.

We will respect that independence. To me that is critical. But if the FASB doesn't go out to the private sector in setting standards, then you lose all of the benefits of having a private-sector body.

So, I feel very strongly that they have to be in touch with people and know what is going on.

Senator GRAMM. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

This is a very interesting discussion. Let me jump to another area. This is one that I would like to pursue because it is a very important area. Senator Corzine and myself and a couple of others have crafted a draft bill proposal that we hope will become at least a starting point to look at some of these ideas, and they touch on many of the things that you have testified to today. It is very much a work in progress and the hearings have been tremendously helpful as we go back and review some of the ideas and suggestions.

In the area of consulting and auditing, we have tried in our proposal to separate out, following the SEC original proposal, so the taxation issue, for instance, would be outside, the IT issue, and the internal auditing outsourcing, for instance, would be different.

And then we leave it up to the audit committee, if there are other matters which the firm would not quite fit into the auditing definition, it would bleed over a bit into the consultative section where you could accommodate that, so as not to have such a stark line drawn.

But you have already kind of discussed this and I do not know how much further you want to pursue it. But we are trying to think creatively on how to get around this issue where you want to have a distinction between consultative and auditing functions, but you do not want to eliminate those, "consultative functions that are critical for performing the audit function." And how you do that is a challenge and we have tried to come up with one idea. It appears there may be many. So if you want to comment on that, fine.

The other thing is the rotation issue.

Contrary to some press accounts today, in our proposal, we say we have to study this and look at it. I gather you are troubled, and I am a little troubled as well. I understand what is behind the idea of rotating the firms. But it strikes me, as practically, not terribly sophisticated—I understand what underlies the concern about not having developing too close a relationship over too many years.

We do this with ambassadors. We limit ambassadorial service to 3 or 4 years. Part of the idea was that, after a period of time, even people who are the best can forget who they represent in time.

Senator GRAMM. They get client-itis.

Senator DODD. You end up discovering that you represent the country you are working in rather than the country that sent you.

Chairman SARBANES. There is a wonderful story. Can I intrude?

Senator DODD. Absolutely. I know the story. It is a great story.

Chairman SARBANES. Well, you tell it.

Senator DODD. No, you tell it.

[Laughter.]

Tell him the story because it is a good one.

Senator GRAMM. Good story.

[Laughter.]

Chairman SARBANES. George Schultz, when he was Secretary of State, before every ambassador would go abroad, he would invite them up to his office to have a discussion with them. He would go over to the globe that he had there and he says, "Point out your country to me." And if they did not point out the United States, then they received a lecture from him.

[Laughter.]

Senator DODD. Invariably, in their enthusiasm, they would be pointing out the country they were being sent to. And the point was, no, no, that is where you are going to work. You are from the United States and you are going to represent us.

Well, that is sort of what is underlying this a bit, I think the motivation, that after a while, you can forget that the letter P in CPA was put there for a purpose, that this is not just a lawyer-client, doctor-patient relationship.

You have a responsibility beyond the one that is paying you, to the person who is looking over your analysis and deciding whether or not to invest in that company. And we rely on that individual, although we did not pay them, in a sense, to perform a service which we are relying on to a great extent to make our financial decisions.

So the notion of having someone who is spending too long a time with someone can end up distorting their vision to some degree.

The problem, the reason we did not write anything in our bill is because when Senator Corzine and I were talking about it, I do not know how you do this with four or five terms. You are dealing with complicated companies where, in the space of 3 or 4 years, you may just really begin to understand a highly complex company. Therefore, when you start to pull someone out and put someone else in, you run into a problem there.

Second, the accounting firms, as I understand it, and you are far more familiar with this, are not cookie cutters of each other. They are not mere images of each other, different firms bring a different

expertise to the table. Some do energy particularly well. Others may do financial services well. And so, by taking one firm and applying it, in a sense, assigning it, if you will, to some other company when they do not really have the expertise, can pose real problems for the P in CPA, for us, the public, who may be relying on it.

But those are our concerns about it.

Chairman PITT. I share those concerns, Senator, and I would say to you, because I agree with everything you have said, there is a tension.

Senator DODD. Yes.

Chairman PITT. But on the one hand, as my dear mother used to say, familiarity can breed contempt, and it also can breed more familiarity.

Senator DODD. Yes.

Chairman PITT. And so, you have to be careful about just how people are performing.

By the same token, empirical data suggests that in the first couple of years of a relationship, and particularly as companies grow more complex, those are the years when auditors are at their most vulnerable.

So if you think about it this way, let's say I am an auditor and I am going to assume the worst about auditors now, even though I do not as a practical proposition.

In my first 2 years, I am not smart enough to know where all the problems are. And in my last year or two, I know I am losing this client, so I do not really care, even if I am now smart.

Now if you have a 5 year rotation, you have knocked off four-fifths of the period. That doesn't answer your concern, however. And your concern is the one that bothers me because of the public interest.

I believe the answer to that is to establish standards for the audit committee to interview the auditors, to talk to the national partners of the audit firm, find out what steps they are taking to review the quality, and then on top of that, to have every year the PAB come in and do a quality control.

This would not be a for-cause thing. It would be a quality control. And if they find that audits are not being done at the highest standards, if they think there is sloppiness or slovenliness, give them the power to take away the client. That to me is the incentive. So that an auditor will know, if I want to keep this client, I have to be tougher, not weaker.

Senator DODD. Let me ask you quickly. My time is up, although the story may have taken some of my time.

On the individual case where—what did we call it? The cooling-off period—people can all of a sudden find themselves moving from having done the audit, moving into the company they are auditing.

There is a logic or an illogic to that that I do not like in the sense of depriving people of the opportunity to have careers and so forth. But there is also a legitimacy to the concern that someone is job-hunting and that dangling out there while you are doing this.

Even, again, the most honest individual can all of a sudden start shading their conclusions here if someone is dangling a pretty significant position.

What are your thoughts on that?

Chairman PITT. Well, I am troubled by the so-called revolving door for exactly the reasons that you have indicated. I think it can give rise to potential problems.

I think, again, however, that it is impossible for any of us to write a rule that will deal with every set of circumstances if we try to decide it is 2 years, no matter what.

My view is, first of all, there may be circumstances where a company is too small and the ability to get somebody from its auditor may provide it with immediate expertise.

Second, there may be circumstances where because somebody has been at the firm, and has some knowledge about the company, they can help clean up a mess that has existed.

So, again, what I would do is say, to me, this is not an area for Federal determination. What I would say to the audit committee is that, in cases of the so-called revolving door, the audit committee should examine the hiring process and decide for itself whether it has assurances that the person will operate independently of the accounting firm.

In that case, it may well be that they take the individual and maybe they get a different accounting firm or it may be that they can do both, or it may be that they look for another individual. But because there are so many possibilities, my concern comes with trying to dictate it.

I have to say, if I were leaning in either direction, the larger companies, which I think have the ability to get more people, this argument doesn't move me as much. And so if you had a rule like this and it applied to the larger companies, perhaps that would make sense.

But I think the best rule would be to put the onus, if you will, on the audit committee. When I say onus, I mean the judgment. Give them the ability to exercise their judgment on behalf of the shareholders so that they can deal with special circumstances.

Senator DODD. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

In listening to my Ranking Member, Senator Gramm, talking about funding sources, it brought to mind the Federal Reserve and their independence and their funding source. We have absolutely no control over what they do.

Chairman PITT. I have noticed.

Senator BUNNING. None. That worries me, too. Believe me.

I want to ask you this question because my basic tendency is to separate auditing from the other functions that auditors are now doing, and separate them with a dark, black line and make sure that they do not get into the financial consulting business with the same firm that they are auditing.

That is the easy way out. But it also is a way that we get public confidence back in the markets. Is there any way you can see that we can build true firewalls between the auditors, the analysts, and the firms they represent? Is there any way we can keep them from knowing what their firms' positions are on other issues? I do not think there is.

Chairman PITT. Let me say this. Firewalls require a lot of effort and, to some extent, a leap of faith. Whether it is a large leap or a small leap I guess depends on your perspective. But they can work. The difficulty is in how you define it.

Suppose I gave you the hypothetical of Company A that wants to buy Company B and merge them, and A is public. They retain their auditors to review the companies to give them a sense of what the auditors think the combined company might look like, and how to value it in that sense. Not a valuation, but just what accounting principles might apply. Technically, that is not an audit. So, somebody might say, well, that is a consulting service, and it probably is. But I think it is a very valuable one.

Senator BUNNING. Let me ask you the question, though.

Chairman PITT. Yes.

Senator BUNNING. Does Company A and Company B have the same auditor? And if they do, then I really have a conflict.

Chairman PITT. There I think Company A would be well advised to get somebody else to look at the situation.

Senator BUNNING. Outside.

Chairman PITT. Not because the accountants may or may not do a good job, but because the shareholders that you report to should be confident that they got a fair deal before the bid is made.

So, yes, that could be a very different factor. And it only proves, my point, which is you might say in a lot of cases it is okay, but in some cases, it wouldn't be okay.

To me, this is why you need a principled basis for saying what the criteria should be, as opposed to trying to write a prescriptive statute that says, well, you can do some internal audit work, but not others, or you cannot do any internal audit work. You cannot do any of this.

The difficulty will always come up, somebody's going to sit there and they are going to have a problem where we will all potentially agree, it makes sense to have the skills brought to bear.

And so, I want to work with this Committee to prevent conflicts and to improve independence. But I think the best way to do that is by coming up with standards as opposed to coming up with a per se ban.

Senator BUNNING. I was in a hearing yesterday where the three credit-rating people were. What kind of things are you going to look into, are you going to inquire into regulations other than the current ones for credit-rating bureaus?

Chairman PITT. I have to start with a fundamental concern.

We have a couple of rules which establish a category of entities called National Securities Rating Organizations, and give them, in effect, some form of a governmental imprimatur. But to my knowledge, we neither do nor probably could do any kind of due diligence. What happens is somebody comes in and they say, we rate one third of all of the public companies in this country and now they are okay.

We want to look at the application of existing rules. We want to look at practices by rating agencies that may affect their ratings because rating agencies provide more than one service, and they too are paid by their clients.

So if you had a circumstance, hypothetically, and I am not suggesting this has happened, where a rating agency was paid for other services and somehow, it took a more benign view of a company's credit situation. You have an immediate conflict of interest and the public never knows that.

There is an analogue in the securities laws. Back in 1933, the Congress, in its wisdom, passed Section 17–B of the 1933 Act, and it says, if you want to make a recommendation about a security and you are getting paid to make that recommendation, then you have to tell people that you were paid before you make your recommendation.

Senator BUNNING. They usually put that in the footnote that this firm may or may not have an equity interest in this firm.

Chairman PITT. Yes. That is what we would I guess refer to as boilerplate. And we moved away from that in the analyst area and I think, to the great credit of the securities industry.

I have no idea whether that is warranted in the rating agency circumstance at all. But I think that this is a business that we need to know a lot more about and decide whether there are any practices in which investors can get a better shake.

Senator BUNNING. My time is expired. Let me just ask you one thing. We only have three recognized agencies in the credit-rating business. It would seem to be more healthy for the SEC and for the public to have more than just three.

Chairman PITT. I agree with you. There are other rating agencies that actually meet what we think are the standards of our rules and some of them have even been invited to come in and apply and they have declined.

At the same time that I agree with your point, I also note that we only have five accounting firms, in a sense, five major accounting firms.

Senator BUNNING. Major.

Chairman PITT. Maybe.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Bunning.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman, and once again, welcome, Chairman Pitt.

A quick point with regard to the revolving door issue. You addressed it as an issue with the accountant working inside the company and the audit committee can make those judgments.

I think the real concern of a lot of us that look at this issue is the set-up of the individual, potentially—put your cynical hat on—that someone compromises how they may interpret a rule while they are the accountant.

Chairman PITT. I agree.

Senator CORZINE. As opposed to what happens after the fact, once they are working inside the company. I think it is a concern that may not even be an active Commission. It may be something that one is really allowing themselves to ingratiate themselves to access it. I think it is a much harder problem to have an audit committee resolve after the fact.

Chairman PITT. I agree with the first part. I think it is a much harder problem. And I think it is a real problem. I am not certain that it is not susceptible to review. You have to do due diligence.

But if you had a presumption against it for larger companies, except where it is shown that there is a bona fide need and there is no reason to believe that independence is impaired, and then there are strictures put in place, you may be able to do that.

All I am saying is I think it is worth looking at instead of having an iron-clad rule. But I do not have a problem with the iron-clad rule for larger public companies.

Senator CORZINE. It appears to me and I suspect Chairman Sarbanes asked these questions because he has asked it regularly, but we have this cascading problem, and you have potential for a set of rules on listed companies. Some would argue that you need to subdivide that, versus small business arrangements. And I think this is a hard sort-out, no matter what kind of initiatives you take.

Chairman PITT. I agree.

Senator CORZINE. But do-able in the context of other regulatory schemes.

I want to make sure that I am hearing what you are saying. You do believe that auditing and consulting should be separated with the same client. Did I hear that? Or am I over-reading?

Chairman PITT. No, you are not over-reading. I believe that the provision of auditing and many consulting services can give rise to a conflict, and therefore, ought not to be permitted.

I do believe that there are some types of things that may be characterized as consulting as to which not only isn't there a conflict, but also there may be a public benefit.

I do not think that it can be written in stone that way. But the basic presumption is, if you are doing one thing for a client, that is what you should do, unless it is clear that the client benefits and the shareholders benefit. There are a lot of concerns in this area and I think public confidence has to be buoyed by creating that kind of distinction.

Senator CORZINE. In your PAB concept, you use quality control as opposed to auditing of the auditors. Can I get you to be a little more expansive about what quality control reviews?

I am trying to think about whether this is an SEC review of a securities firm. I only think in analogies where I have actually gone through some of these life experiences. And NASD review, maybe pre-1995 and post-1995. But how are you perceiving what a quality control review is?

Chairman PITT. I think there are a lot of elements that go into quality control.

First of all, you want to find out how the audits are structured. What type of decisions are being made, what educational level and ethical training do the people who are on the frontline have?

What types of restrictions has the firm imposed to make sure that the people on the line get the best quality?

To what extent are the engagement partners and the rest of the audit team supervised by national partners who are far more expert in the more complicated nuances of accounting?

How was a particular audit actually conducted?

This is, in effect, a not-for-cause inspection as in the securities industry, if somebody comes in just to see how you maintain your files, how you handle a customer account and so on. The larger firms need to be reviewed, in my view, on a yearly basis.

Senator CORZINE. Do you anticipate that being that you look at a specific client audit, or are you saying, we are going to go look at Arthur Andersen's laying out of what the framework of the audit will be about?

Chairman PITT. Both. I think it is both.

Senator CORZINE. So, you really are talking about an audit of the auditors.

Chairman PITT. Yes. And if we have that, if we have that system, it would be my belief that our Office of Compliance, Inspections and Examination would have to audit the PAB. That is to say, we would see what kind of a job they were doing, which of course, right now, we do not do. The Commission has never looked at the POB.

Senator CORZINE. Are you basically suggesting that the peer review process is not hacking it with respect to making sure that the audit of the auditors brings the confidence that I think that the public, or at least I believe the public, should reasonably expect?

Chairman PITT. Also to assure that the particular firm, as you look at an audit or two, is applying the highest standards in the profession, not applying bare bones standards.

If that evaluation were made, the PAB could say, listen, you may not have done anything illegal. You may not have even done anything unethical. But given the way you have handled this client, it is our view that either you are too cozy with it or you were too sloppy with it, and we are telling the client it has to find a new auditor.

It seems to me that would be one of the punishments. To me that is the way that you deal with rotation. You have it as a meaningful stick, so that firms are afraid that if they do not do the best possible job, they will lose their clients.

Senator CORZINE. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

Thank you, Chairman Pitt. I am sure you have anticipated my comments and reactions to your last statement made to Senator Corzine.

I am very nervous about rotation. The reason you have given being perhaps the most cogent, that when you know you are going to lose the client, but you know you have him for the full 5 years, you take him for granted and, okay, I won it. It is an old story we have heard.

We have told stories around here before about the real estate developer who died and had his choice of going to heaven or hell. When Satan showed him around hell, it looked really, really wonderful, to the point that he actually decided, I am more at home here. I have more friends here. I feel more comfortable here. I am going to choose hell. And the next day, after he had made his

choice, things were not wonderful. He checked into the head office and said, wait a minute. You promised me this, this and this, and you haven't done any of it. What's the story? And Satan said, you are a developer in the real estate business. You should understand this perfectly. Yesterday, you were a prospect. Today, you are a tenant.

[Laughter.]

I think that may very well arise if you get into this rotation. Okay. I have you locked in for 5 years. I will give you perfunctory service and spend my time trying to woo the next one that I am going to go after when this 5 years is up.

A variation on the theme you just described for your consideration and maybe comment. As long as we are using analogies, let's take it out of the sports world, where you sign up a star player for X-number of years and at the end of that contract, he is a free agent. You do not want to lose him. You go to every extreme you can, within your financial limits, to hang onto him. But other teams are bidding for him.

So that there is an understanding that after 5 years, to pick the date that has been picked, the company has to put this out for bid.

Now the incumbent auditor can bid on it and has a chance of hanging onto it. But he knows that if he does not serve the needs of the client properly during the 5 years, at the end of the 5 year period, when the bidding time comes up, one of the others will be more attractive. This is a variation on the theme that you have described, and maybe the two can be merged together. Can you comment on that?

Chairman PITT. Yes. I think that something like that could have very positive benefits. First of all, I would move the decision as to who hires the auditor from management to the audit committee. The same thing, I would move the decision as to whether you replace the auditor with another audit firm to the audit committee.

I am not saying that management won't make recommendations and present them. I am just saying I would like the audit committee to be able to review that and understand what is going on.

Senator BENNETT. If I could interject, when I was a CEO of a publicly-traded company, that was de facto the case. If the audit committee of the board and the CFO came to me in tandem and said, we are not getting what we need out of this auditor, I did not try to second-guess them.

Chairman PITT. Many companies do that today. However, I think the proposition you are suggesting has a great deal of attraction. There is one concern I have and I do not think that your proposal either exacerbates it or eliminates it. I think your proposal is neutral to this.

One of the concerns I have had about the way auditing services have been marketed to date, and it is not something that is talked about very much, is that public companies may say to an auditor, you are proposing to charge me $20 million for my audit. I am not going to pay $20 million. I will pay $10 million, and I will give you four or five other projects that will give us value and you value.

Obviously, it is none of the Government's business what people charge, and I wouldn't ever want to get into that business. But what does concern me is, I do not want to create a situation in

which, basically, what you wind up with is, in the free agent market, you have people who basically make a decision and can move away. And here, it is a buyer's market.

The one problem you have with the analogy to the sports world is that an Elvis Grbac can be bid on by a lot of firms and Grbac makes the decision. Here, what is happening is that the Washington Redskins are making the decision and therefore, they could push the price in a lower direction.

Senator BENNETT. Well, you stimulate so many things that I could say in response that I will have to be very careful and try to be quick.

Two observations. Number one, there is an assumption in most of this conversation—I know that you are sophisticated enough that you do not share it, but it is certainly there with most editorial writers—that accounting is a commodity.

Chairman PITT. Right.

Senator BENNETT. That an accountant is an accountant is an accountant. One accounting firm is just as good as another, and we can switch these things. It is just like switching one bushel of wheat for another bushel of wheat. It is a commodity.

My own experience makes it very clear that is not the case.

Chairman PITT. Absolutely right.

Senator BENNETT. Many, many times, the decision to move from Accounting Firm A to Accounting Firm B has nothing whatever to do with conflicts of interest or transparency or anything else.

In my case, we fired, at that point, a Big Six accounting firm, and I am very disturbed to see that now it is toward a Big Four, and if we can figure out some way to get it back up to the Big Eight, I would be very grateful.

We fired a Big Six accounting firm because the partner in Salt Lake City who was handling our affairs got transferred. He was promoted and his replacement was, in our view, incompetent. And we went to another Big Six accounting firm for that purpose.

Chairman PITT. You have put your finger on something, and I completely agree with everything you have said. Accounting is not a commodity.

But, again, if the CEO hypothetically is the one that is making this decision, and the CEO's compensation depends on the profit numbers, and he has two auditing firms, one of whom is coming in at twice the price of another and he realizes if he can save several millions of dollars, it may affect his business, he has his own built-in conflict.

That is why I want to move this to the audit committee. Once you do that, you then tell the audit committee, you are not required to make this decision on the basis of any particular factor. You should use your business judgment. You do what you think is in the best interests of the company and its shareholders. But the guy who is getting paid for producing a short-term number may treat it as if it were a commodity.

Senator BENNETT. Well, one last comment. The audit committees of the boards with which I served would have taken into account the economist cost.

Chairman PITT. I think they should take it into account.

Senator BENNETT. Just as much. But, as you say, it would not be the driving force.

Chairman PITT. Exactly.

Senator BENNETT. I had an audit committee that said, we are going with this firm rather than this firm because, frankly, this firm is over-auditing us, demanding to see papers they really do not need to see just so they can run up the bill. And this firm, which is equally as competent, knows that they can produce an audited statement for, that meets all standards without their taking advantage of a CFO who wasn't confident enough of his numbers.

Frankly, I changed auditors. I changed CFO's at the same time.

Chairman PITT. Exactly.

Senator BENNETT. Thank you.

Chairman SARBANES. Thank you, Senator Bennett.

Senator Schumer.

COMMENTS OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman.

Thank you, Chairman Pitt. I have a few questions.

First, I know my colleague, Senator Corzine, asked a little bit about something I have been very interested in, this uber-auditor.

I think that having the SEC occasionally do audits or investigations might really have a prophylactic effect in a whole lot of places, the way people fear an IRS audit. You could not do it that often, but doing it every so often, particularly when maybe you would smell a rat, would be very worthwhile.

My questions are: What currently actually triggers an SEC investigation into accounting practices? Is it ever done randomly the way IRS audits are? And how successful have they been, not just in the particular area you have looked into, but as a prophylactic?

Chairman PITT. Actually, I think that question is worth a lot of reflection because it goes to some very core issues.

The Commission commences an investigation when it believes there is a reason to think that somebody has done something wrong. You can get a confidential informant. You can get a restatement. You can get short-sellers who make statements, forensic accountants who raise problems.

We have an Office of Inspection, Compliance and Examination. They do not review audit firms. They do not review corporations. They do not review law firms. If we had a private-sector regulatory body like the PAB that we have proposed, my view would be that we would have to do inspections of the PAB and through that, look at some of their inspections or quality-control reviews of firms.

Senator SCHUMER. So, you would need a lot more staff to do that, I imagine.

Chairman PITT. We would need more staff, or at least we would have to find people who were both competent and not doing something else that was critical. I do not know yet how much staff we would need. But this is not going to be a simple process, and we would want people to be trained before they went out into the world and raised problems.

Senator SCHUMER. What would be the difference between having the SEC directly do its own auditing, a separate unit, looking here, looking there, and having it be done as looking over the shoulder

of this PAB? Why would you prefer that proposal, that approach, to the one that I have mentioned here?

Chairman PITT. The reason, and this is something that I actually—it is hard to say this about auditing issues, but it is something that I feel passionately about.

Chairman SARBANES. I am sorry Senator Enzi's not here to hear the comment.

[Laughter.]

Chairman SARBANES. We will certainly communicate that to him.

[Laughter.]

Chairman PITT. I waited until he left.

[Laughter.]

But the difference is this. What you want are people who are professional enough and have enough experience and who are properly compensated to do this kind of a job. I do not think that the Government is capable of doing this job directly by itself, and if it did do it, I do not think it would do it well.

Beyond that, even if it could do it and even if it could do it well, because Government will never pay for the talent that is really needed, you are not likely to get the best people. And if it did pay for the talent, we are talking about hundreds of millions of dollars, which I could not justify. I think the private sector can pick this up quite well.

Senator SCHUMER. The next question is about stock options.

Chairman Greenspan has said publicly—I know he said it to me and I think he has now said it publicly—that if he could do one thing to learn from what has happened with Enron, the auditing and everything else, he would expense stock options because it has created a climate where too much of top management is interested in the stock price, unrelated to the performance of the company. Do you agree with him?

Chairman PITT. Well, first of all, I am always reluctant to disagree with Chairman Greenspan. But I would say this. I think the short-term mentality and the short-term profit incentives that are placed on CEO's is very detrimental.

As far as I am concerned, the FASB spent an inordinate amount of time looking at the stock options question. The result they came up with requires companies to show what the impact would be. They can either expense it or they can disclose what the impact would have been had they expensed it, so that shareholders who want that information can get it.

Whether that decision is right or wrong, I think is open to very serious debate on both sides of the issue.

Senator SCHUMER. What is the argument against expensing.

Chairman PITT. I am sorry?

Senator SCHUMER. It is an expense.

Chairman PITT. Yes.

Senator SCHUMER. What is the argument against expensing? You could decide to expense it at different points.

Chairman PITT. It may well be an expense, depending upon what happens with the options and how they are exercised. But my view is this.

Senator SCHUMER. Once they are exercised, how are they not an expense?

Chairman PITT. If they are exercised, then, obviously, you are in a different posture. But the point I was making is that having gone through this exercise, I would be exceedingly reluctant to reopen the issue.

There are a lot of arguments on both sides of this question and my reaction is, we have so many other things to do, the FASB in 27 years has not yet given us revenue recognition policies. To me, that is critical. This is, in my view, not an issue.

I guess the one place where I would take exception with Chairman Greenspan is, I do not think that the nonexpensing of options caused what happened in Enron. I do not think any one thing caused what happened in Enron. But I certainly do not think the nonexpensing of options created that problem.

Chairman SARBANES. Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

Chairman Pitt, welcome. Thank you for joining us today and for your testimony.

I would like to have us focus a little bit on the audit committee and the role of the audit committee. What I have tried to do over the last month or so is to talk to a lot of people in my State who are involved in corporations and corporate boards and those who in some cases oversee them.

We have met with folks from a number of auditing firms and accounting firms to try to understand different aspects of the issues that are either going to get some kind of Congressional attention or not.

One of the things I have tried to learn about is to better understand the role of the audit committee and who should end up on the audit committee, the kinds of expertise they need to have, and to the extent that they do not have the level of expertise that is needed to enable them to play their appropriate role, how might they get it.

Chairman PITT. Senator, before I give you what I hope is a direct response to your question, I do want to make one observation which may be helpful.

I believe that the audit committee process is incredibly valuable. It is good to have outside people, wholly independent, looking at something.

Much of my corporate practice when I was a lawyer was advising audit committees. But I will also tell you that, no matter what the expertise is, at the end of the day, if management is going to play games, no matter how determined, how smart, and how experienced the audit committee is, they are not going to find it.

The best you can hope for is to have a process. And to have that process, you need people with expertise.

You want people, first of all, who have some knowledge of accounting. You want people who have some knowledge of corporate internal controls and record-keeping. You also want people who are sufficiently intelligent, that they are not going to just sit in a room for 25 minutes, get a presentation, and then leave. They are going to ask a lot of questions.

We held a roundtable on the whole issue and Warren Buffett was at our roundtable in New York on March 4. He came out with a list of questions that he thought people had to ask.

Senator CARPER. People on the audit committee had to ask?

Chairman PITT. The audit committee had to ask. And the questions were actually—it is the test of a really brilliant idea. When you hear it, you say, that is so simple. Why didn't I think of it?

His approach to that I think was right on. What I used to do when I represented audit committees was to help them focus on the questions. And then when they got the answers, help them focus on follow-up questions so that they did not just accept what they heard.

It is not an easy job. It is one of the reasons why I worry about putting too much pressure on audit committees, or even potentially, depriving them of a reasonable standard of liability.

Senator CARPER. When you have a board assembled and you look at the board and you do not have people with the kind of expertise, maybe they are bright, but they do not have the kind of expertise that you have alluded to, what can be done to help them gain that level of expertise?

Chairman PITT. Well, I think there are a number of things that can be done.

The audit committee has to have the independent authority to hire whatever expertise they think they need.

Senator CARPER. Should the audit committee be hiring the independent auditor and should the independent auditor be reporting to the audit committee, as opposed to the CEO of the company?

Chairman PITT. That is correct. That is something that I believe quite strongly, that the audit committee should do the hiring. But I also believe, if the audit committee is hearing something and they are not certain they understand it, that there are really two issues.

First, do you understand what is going on? And sometimes people are embarrassed to admit, I do not understand this. They need assistance, expertise, lawyers, accountants, who will help them say, I do not get it. I need to understand this.

In addition, I think there ought to be training programs. We organized raining programs for the audit committees we represented. We would have people from various accounting firms, various MBA's and others, come in and talk to them.

A second area of expertise that I think people need, and it is one that we want to bring into the Commission, frankly, is risk management.

I think if an audit committee, and many companies do not do this. The securities industry has made great use of risk management. But I think if the audit committee can tap into risk management expertise and say, tell me, with companies that are in this kind of business, where should I be looking for the problems?

That would be a very, very useful effort on the part of an audit committee.

Senator CARPER. I know my colleagues have participated in a number of sessions outside of these hearings to get input. We had a real good session in Delaware earlier this week, talking about the motivation of the board to really engage in spirited oversight.

One of the very bright people with whom we were meeting suggested that maybe we consider requiring directors to have a meaningful, long-term equity position that they could not sell, or should not be able to sell, except under some very unusual circumstances while they are on the board, and suggested that that kind of requirement might provide directors with the incentive that they need to engage in aggressive oversight. Would you just react to that?

Chairman PITT. Yes. Let me just say, on the substance of that, I could not agree more. That is one of the reasons why we have made it a policy, and it was directed from the President, that where people are getting compensated on a short-term basis, but it is really a sham, they have to give it back.

The better way to do it would be to basically say, you cannot have the compensation unless it has been evolved over the long-term. So, as a policy matter, I think that is what a lot of corporations should consider doing.

Where I start to have a problem is who makes them do it? And part of my problem is, I do not think that the SEC should be taking over the governance of corporations. I think what we should do is use our bully pulpit to say to people and investors, this would be a best practice. This is the kind of thing that people should do.

I am not at the point where I would be in favor of adopting a rule or recommending that you legislate the area.

Senator CARPER. Thank you.

Mr. Chairman, thank you.

Chairman SARBANES. Yes, thank you, Senator Carper.

I have a few questions that I want to add, and I am sure my colleagues may as well.

First of all, I think Senator Schumer probably covered this, but I was going to ask you this question. You are the Chairman of the Securities and Exchange Commission. Why shouldn't the Securities and Exchange Commission do these things directly, the things that you are going to put into this statutory, regulatory organization?

I take it that your answer to that is we cannot get the good people to pay them enough money to do the job. Is that it, essentially?

Chairman PITT. That's an answer. I think that we won't do it as well, but I think there is a more fundamental, substantive reason.

I see what we want from the audit profession as having three levels. We want them to obey the law and not do anything fraudulent or illegal. We want them to have the highest set of ethics. And we want them to be the most competent they can be.

The SEC is terrific at the first of those. We can make people abide by the law. But I think it has been shown that if you have an effective system of private regulation, the setting of ethical standards and the setting of competent standards can be better done through that vehicle than the Government is able to do it. That was the whole philosophy of the securities industry. And what it gives investors is a three-fold protection instead of a one-part protection.

Chairman SARBANES. Do you think we have achieved a pretty good situation with respect to the securities dealers through the workings of the NASD in terms of setting appropriate standards, monitoring them, disciplining them, policing, and so forth?

Chairman PITT. I think that the level of industry policing, both by the NASD and by the NYSE has been improving constantly. My view is, as with everything, it is not perfect. There are places where improvements can occur. But I think it is a system that is now serving the public interest exactly as Congress has intended it to do.

Chairman SARBANES. Do you think that is, if not a model, at least something we should look at as we try to formulate how we are going to handle the problems that have arisen in the accounting field?

Chairman PITT. I believe we should look at that model. The accounting profession is different from the securities industry. But I have spent a number of hours with people from the NASD. We had people from the New York Stock Exchange participate in our roundtables and we are consulting with them to get their input on it. There are some areas where I think there is a direct correlation, but others where there may not be.

Chairman SARBANES. We had Bob Glauber, Chairman and CEO of the NASD, as a witness at one of our panels. It is very interesting what they are doing. Of course, they have a very full-fledged operation. They have a staff of 2,000 employees, a budget of $400 million, and they really investigate infractions, discipline people, including significant fines, or even expulsion from the industry.

Chairman PITT. Absolutely. That is what we want in the accounting profession. That type of discipline is very good and that is why I have spent a fair amount of time with Bob Glauber. I am very impressed with what he is doing there.

Chairman SARBANES. I wanted to ask a question about consultation, in a friendly way.

Aulana Peters testified about the Public Oversight Board and what, amongst other things, prompted them to step down, and made the point that, while you had consulted with the accounting firms, there had really not been a consultation with them. In fact, she went so far as to say that the POB, the independent body charged with oversight of the accounting profession, and in that regard, assigned the duty to act in the public interest, was effectively excluded from a process of great moment for the profession and the public it serves. And the fact that you had been in discussion with the Big 5.

That really raises an issue that also we have been hearing from others about how broad and extensive the consultation the SEC is engaging in.

Now, we did these hearings. We tried to cover the waterfront, so to speak, and to make sure that everyone had an opportunity. And I have found in the past that sometimes you may have very sharp exchanges with people and you do not really agree with them. Later, when you reflect about what they have said and what the discussion was, out of that comes some important perception.

We had a panel yesterday, the Council of Institutional Investors, the Consumer Federation of America, the AFL–CIO, and the Association of Investment Management and Research on that panel.

I am just kind of curious, has the SEC been, in a sense, in consultation with them or been having direct opportunity to hear from

them as you wrestle with these problems? To what extent are they folded in to your consultation process?

I think one of the reasons your initial proposal met the kind of, some of the negative comment on it, was that it was perceived as having been a proposal that emanated from a discussion between the SEC and the five accounting firms and not extended beyond that. And, of course, you did have the Public Oversight Board on the scene.

So, I am just curious what your approach is to this consultation question and how extensively it has been done to this point. And if not done extensively, whether that could be addressed as we move ahead.

Chairman PITT. Actually, I am pleased you asked the question. I do not take it as an unfriendly question. I think you have a perfect right to ask it and you deserve a clear answer.

First, let me say that I understand what Mr. Bowsher and Aulana Peters said about the reason why some of the POB members voted to disband. And I am really not going to get down in the muck with some of the accusations that some people have made. But let me answer your question more directly.

We consulted on accounting regulation with the POB long before we consulted with the CEO's of the companies. Mr. Bowsher had been to my office. His lawyer, Alan Levenson, had been in repeated conversations and phone calls with me. And long before we ever met with any of the CEO's, I had a specific conversation with Mr. Levenson in which I said, when we finally come up with a proposal, we want the POB to be a part of this.

The first point I will make is that, I like to talk to everybody. I do not have a lock on what the right answers are. And I find that by listening to others, I learn a great deal. Mr. Bowsher had a lot of experience, which is why he was in my office and we met.

Now when we announced the structure of what we were thinking about, I went to great pains to make it clear that this was something for people to start to think about and we would then meet with people about what we had in mind.

So when the POB voted to terminate its existence, I wrote them a letter. I noticed that when Mr. Bowsher testified, he gave you the letters that he wrote. But he did not give you the responsive letters that he got from me.

Chairman SARBANES. Well, we have all the letters, so that is not a problem for us.

Chairman PITT. I hope so.

Chairman SARBANES. Yes.

Chairman PITT. I first wrote him a letter and said that I thought their action was unfortunate. My view was that I wanted them to have a role to play and to learn from their expertise. But what I was not going to do is keep the POB unchanged because I believed it was flawed: Its funding came from the AICPA; it has no disciplinary power whatsoever; and its peer review was viewed as, you scratch my back, I will scratch another. And it was unsatisfactory to me to continue with the POB, and I think Mr. Bowsher knew that because I told it to him.

Nonetheless, I told him that I wanted to understand their views. I then spoke with every single member of the POB, met personally

with Mr. Bowsher in San Diego, and then attended a meeting with the POB where I made all the statements I have already made to you. I said, we need your expertise; we would like your assistance. It is in the public interest for you to help us, and that is what we would like you to do.

But having just said that, let me now talk about the CEO's of the accounting firms because I take this as a point of great concern to me.

I represented a lot of people when I was in private practice. And I do not believe in guilt by occupation.

When I came here and took an oath of office, and you had me under oath at my confirmation hearings, I told you that I had only one client now, and that was the public investor. I meant it, and anybody who knows how I have performed will tell you that is exactly what happened.

When I saw things deteriorating in the accounting profession, I asked the CEO's of the major firms and the AICPA to come to a meeting. And at that meeting, it was very simple. Nobody negotiated. Nobody talked about what kind of a deal we could make.

I basically laid down the law to them. I said, there are problems here and either the profession is going to step up to the plate and take responsibility for cleaning up the public perception, or it is going to be done to it. It may be done by us. It may be done by Congress. It may be done by the courts or it may be done by all of the above. And I then said, there are all sorts of things that you are going to have to deal with and you are going to have to deal with popular perception.

So knowing what I think is required, you come back with something. And if you do not, then I will come up with something.

Those were my negotiations.

I said at a press conference, and I will say it here, I do not negotiate about the public interest. I did not negotiate with any members of the accounting profession or the AICPA.

What I think we have come up with—and we have laid it out as strongly as we can in this very lengthy statement—is something that this Congress should be proud of. I know we would be. And that is why we have a unanimous view on the Commission vis-à-vis our testimony.

Chairman SARBANES. Have you consulted with these groups that we heard from yesterday that I asked you about? What is the nature of that consultation?

Chairman PITT. Yes. I have consulted with investor groups: The Consumer Federation of America, Barbara Roper will tell you. I have had Mel Minnow in. I have had people from Calpers in. For example, with the Consumer Federation of America, I reached out to them. I did not wait for them to call me.

I will say that there are clearly differences in the way some people behave. Some people pick up the phone and call you first, some people wait for you to call. But there is no group that I will not talk to and, indeed, I talk to every group.

You may recall, and this is off the point, one of the questions you asked me at my confirmation hearing was about the union. One of the first things I did when I took office was to invite the union representatives to my office to tell me what their problems were. And

the fellow who is the local union leader, said: I have been at the SEC for 11 years. This is the first time I have ever seen the Chairman's office.

There is no one that I won't listen to.

With respect to some of the other things, I do want you to know that we have had roundtables and Barbara Roper, again of the Consumer Federation, is scheduled to appear at our Chicago roundtable, which is set for April 4. Sarah Teslik of the CII is scheduled to meet with the SEC on March 26. And I spoke at the annual meeting of the Consumer Federation of America where I announced that we would hold an investor summit.

I am very committed to investor protection and I take my oath of office very, very seriously.

Chairman SARBANES. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

I first want to say that—and I know the Chairman did not imply this in any way, so I am not responding to what he said—but I think talking to the accounting firms is vitally important.

One of the things that disturbs me about this process we have been going through in the last year is this feeling that there is somehow something corrupting about talking to people.

You know that there has been this effort to pin Enron on the Administration. Things that are held out as potential proof is that somebody listened to what somebody said.

I cannot imagine a country in which the president of one of the largest companies in America calls to talk to a Government official and cannot talk to him. I think setting down how things are going to be with the Big 5 accounting firms is important, but I also think listening to them is important. And I want to share a little story.

When I first came to Congress, we had a bill on the floor about hazardous waste. And it had to do with small generators of hazardous waste. As you can imagine, nobody in Congress knew anything about the subject and therefore, we were legislating on it.

[Laughter.]

I received a letter from a little garage in my district. This is in essence what the letter said. I read the letter on the floor of the House of Representatives. He said: I am pretty responsible. When I get crankcase oil or solvents, I collect them and I put them in a barrel. And then when the barrel is full, I call the guy from the waste disposal company and he comes by and gets them.

But let me tell you something, he said. If you make me assume liability for what he does after he puts that barrel on his truck, if you make me keep a long list of paperwork, you know what I am going to do? I am going to take those hazardous wastes and I am going to flush them down the toilet and I am going to let the City of Bron worry about it.

Now, somebody could say, well, my God, you were corrupted by talking to potential polluters.

The point is, when I read that letter on the floor of the House of Representatives, we changed the bill and took into account these small people who were generating relatively small amounts of hazardous waste, and I think came up with a procedure whereby this guy won't be flushing the stuff down the toilet.

I am probably overstating the case, but I am really concerned about this idea that listening to people and talking to people is corrupting. The Constitution guarantees the right of people to petition the Government. I just think it is vitally important that we never get defensive about talking to people or listening to people, especially people that are involved.

Quite frankly, I have regard for every self-appointed group in the world, many of them who have no constituencies whatsoever. I represent more consumers than any group in America. I have 21 million consumers. I am an embodiment of consumer interest in this country.

[Laughter.]

I think it is important that you listen to them. But I do not think it is important that you listen to them as it is that you listen to the people who actually are involved in the business.

So, I just wanted to make that pitch. I think it is very important to listen to everybody. And from what you have said, it is clear to me that you are willing to meet with and listen to anybody, and I think that is commendable.

I am not trying to set differential levels, but I do believe if you are going to impose a rule on the accounting profession, or if you are going to set hazardous waste standards for garages and filling stations, the most important visit, the most important person to listen to is somebody who is in the accounting business or somebody who is running a garage or somebody who is running a filling station. And if we ever get to the point where you are tainted by talking to people, then the whole system is going to break down.

Chairman PITT. I just want to say, I could not agree more with everything you have said. I do want to make one other observation.

My first crisis was not Enron. It was 9/11. And the first thing I did was get together the heads of all of the major brokerage firms and the major marketplaces, and we started to talk about what the public interest required.

We received great acclaim for doing that. People said, that was a great approach. You listened to people. The way it worked was terrific.

When Enron hit, I did exactly the same thing. But now people were saying, let's look at all the people this fellow has represented in his lifetime because, after all, this is a political mess, they think, and therefore, nobody's bona fides are above reproach.

Senator GRAMM. If I could just say in conclusion on that, their tactic is an old tactic that was used in Nazi Germany. Their tactic is guilt by association and trying to exclude people from having an opportunity to have their say.

Chairman SARBANES. Well, now, I think this thing is getting carried away here.

[Laughter.]

Let me just try to get it back into a little focus. The test of your stewardship will be the substance of what is done.

Chairman PITT. Exactly.

Chairman SARBANES. We recognized at the time that you were nominated what you had done over your career and the premise, at least on my part, in carrying forward that nomination was the belief that you could drop at the door, in effect, the clients of your

private practice when you went into the public office, and that, in effect, what would renew itself would be the commitment you had when you were at the SEC, when you became its youngest general counsel in its history, and the commitment to the public interest that marked your private career as well, and of course, you represented clients within that context, which is what lawyers do under our system and we recognize that.

Obviously, questions were raised at the time. Presumably, questions will continue to be raised. So there is an extra burden, in a sense, given the history to produce the substance, and of course, that is what we are searching to do here.

Now, I think you have an affirmative obligation to reach out for consultation. I do not think it is enough to say, well, if they get in touch with us or they communicate with us, why, we will try to be responsive.

I think there is an obligation on the Commission to make sure that it is reached out and heard from everyone, so we do not have people saying, well, you know, we represent investors and we have a long history of doing that, and we have a concern here, and we do not feel that our concerns are getting through. Obviously, we shouldn't run into that.

But the test here for all of us is going to be what we can produce on substance because you can review the records of Members of the Congress and find one thing or another that would raise a question as to with what frame of mind do they come to the issue?

That is the thing, obviously, we have to work on in the weeks ahead, to put together a structure here that will work.

This structure has not worked. No one has come to us and said that the existing structure was working okay and we just essentially ought to leave it alone. No one has said that. Therefore, the question now is what do we do about it and how do we remedy this situation, and that is what we are focused on.

In that regard, I just want to leave one thought with you.

You are a very nuanced thinker and I respect that. But it seems to me that we are now working in an area where we are going to have to draw some bright lines. I am not out to draw anything but bright lines, and it seems to me we have reached that point.

I think in a sense, if you look at something and you say, well, that will work for 99 percent of the times, but there is this 1 percent when it may not work. And therefore, we have to leave it open to take care of that 1 percent, that is a way of thinking that I am used to, but not when you are under this kind of, what I regard as something of a crisis situation.

So, I think as we move to try to deal with this, we cannot have it all so loose and flexible that it is open again to sliding down the slippery slope and having a renewal of many of these problems.

That is one of the things we have to work at. That is why I went through that questioning earlier, because I was trying to take a scalpel in order to see if we cannot draw the lines. Not a meat axe. We understand the problems that are associated with that.

Chairman PITT. May I just say one thing on that? I apologize, because I agree completely with what you have said.

Part of the reason I was so successful in private practice was because I was pragmatic. When people did something or came to me

with something that I thought was a problem, I was not afraid to tell them that it was a problem. And when people asked me to find a solution, I wasn't afraid to find a solution, provided it was in the public interest. And so, I could not agree with you more. I am not interested in defeating something here. I am interested in working with you.

I think you have shown great concern for the small investor. I have enormous admiration, as well as respect, for what you are doing and I want to be a helper, a participant, even perhaps a partner, in working with you and the rest of the Committee to come up with the very best structure we know how.

The other thing I do want to say is, I do reach out to people. I have reached out to everyone. And in particular, I can assure you that the CEO's and the AICPA did not reach out to me for that meeting. They would have been just as happy if they never had it. But I reached out to them.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

I do not really have anything to add on this outreach issue. But being someone who tries to formulate policy or previously, responses to business situations, both the timing of when you see people and the amount of time that you spend in delving into how ideas are generated, was also an important ingredient.

Some of the kinds of conflicts that sometimes come after the fact reflect the chronology and the timing of the proposals.

If the horse is out of the barn with regard to a proposal, then some people can feel like, well, they may have been consulted for changes, not really in the formative stage.

More important, I would like to go back to FASB and its role in a new structure.

I am a little troubled. I look at your testimony on page 36 which has to do with FASB's agenda and you talk about revenue recognition, taking 27 years to get to a proposal. Then I read on page 35 of your discussion about accounting standard setting and making an eloquent case why Federalization would be such a horrible idea because it is so laborious and subject to political interference and lacking in flexibility.

Then I turn around to the discussion that goes on about FASB's agenda over the last 27 years, when we have had Republicans and Democrats and it is not a matter of partisanship. It is a matter of this doesn't seem to have worked in a lot of ways in getting to the right kinds of answers.

Some of it may be the SEC. I think one of the questions we have to ask ourselves while we are going through this process of how we put this structure together, your PAB or somebody else's independent regulatory board, should FASB be a part? I think we all agree that it needs independent funding so that it doesn't have to use the tin cup to go to those that it is proposing rules to come up with the resources to be able to come up with it.

You could also have a strong case that the information that you gain from auditing the auditors and understanding the practical applications of what you do, relates to how FASB might want to set principles or maybe get completely out of the rulemaking business. I doubt it.

But if that were the case, how do you feel about making all of those elements responsive through a coordinated chain of command, if you would, as opposed to having them separate and independent in different formats?

Chairman PITT. Well, I am usually never in doubt about things, although I am seldom right. But on this, I will tell you, my instinct says that if you have had a stand-alone organization and you now try to squeeze it into some other organization, you have to be certain that you are not going to diminish what you already have, and I think there are real problems with it.

I am also going to tell you that I do not think there is absolute truth on that issue.

What I think has to be coordinated is the fund-raising. I do not think you can have an FAF that goes out and seeks voluntary contributions for FASB and then have a PAB over here that has involuntary contributions.

At least as to fund-raising—not fund-raising as to fees and revenues—I think they need to come from the same source. You cannot keep going back to people more than once and so on.

As to whether they are stand-alone or not, my instinct is that setting accounting standards is sufficiently discrete that it could be separate. And if you said to me, you wanted it to be together, I would say great. If you want me to help you draft it, I will.

Senator CORZINE. Two observations. One, the NASD and the New York Stock Exchange models tend to combine those because they use the information that is available, I think, and people think is a reasonable model. And two, I really would like to hear your observation on how you think FASB actually has worked.

Senator GRAMM. Jon, would you talk into the microphone, I cannot hear you.

Senator CORZINE. I am trying. Good Lord, I am trying.

Senator GRAMM. I want to know what you are saying.

[Laughter.]

Senator CORZINE. I would love to hear your comments with regard to the NASD and the New York Stock Exchange as its relative model, which I think we have talked about. Then I would like to hear your observations on the functioning of FASB, why it has not worked or has worked, or whether you feel good about that process.

Chairman PITT. I think the NASD and the New York Stock Exchange have one thing in common—they reflect a Congressional notion of self-regulation and the idea that self-regulation can work.

I think the NASD now reflects the notion that when you have a proprietary activity—namely, running a marketplace—and where capital becomes very important to that proprietary activity, maybe it is easier to regulate that market if you separate regulation from proprietary activity.

The New York Stock Exchange has gone in a different way and we stand in review of both of them to make sure that the quality of regulation is the same, notwithstanding that.

But when I thought about the PAB, the model I looked at was the NASD and the New York Stock Exchange, and it is why I spent time with Glauber. I have had several meetings with him. Why I have spent time with Dick Grasso. And why I have tried to build

in what I think is acceptable in those areas, recognizing that accounting is a profession and it does have a different predicate.

I think the models that those two self-regulatory bodies have provided are excellent with one exception—I think given the lack of public confidence that has arisen, and some of it is incredibly well deserved. Some of it is just hype. But there is a lack of confidence. We cannot have self-regulation of the accounting profession.

So the place where I have moved the model is to say, I think you have to have private-sector regulation, but not self-regulation. I do not think self-regulation will produce the confidence that I want.

As to how FASB has worked, it is very easy for me to tell you that FASB has not worked as well as I think it was intended to work. I think that the accounting standards that we have in this country, as of this moment, are the best in the world. And FASB has produced a lot of those accounting standards. The people there have been very thoughtful. They are very smart. They are very bright, and they are very well-intended. And so, to that extent, I do not want to move away from FASB.

What has not worked is that they have had difficulty raising funds. They have been subject to political pressure. And they have approached the issue of dealing with setting out accounting principles as if they were writing a trust indenture. And to my way of thinking, the world has moved away from that. Whether it was always that way or not is really of little relevance to me.

If FASB continues the way it is now, we will have big problems. But I think it has done a very credible and fine job in a number of areas. I think it can be materially improved and the views that we have talked to them about, which they have been quite accepting of—they are reducing the size of the Board. It is now going to be five and they are going to adopt rules by a majority. I have told them I want them to shoot for a 60 to 90 day turn-around period on proposals, and that we will respect what they come up with, but they have to come up with something.

They won't do 60 to 90 days, but they will do better than 5 years or 10 years. They won't give us 800-paragraph principles any more. They will give us much broader principles that will be the kind of appropriate approach that we need and won't allow people to use check-the-box mentality to justify having billions of dollars in off-the-financial-statement liabilities that nobody knows about.

I said early on when Enron hit, and I am not commenting about what happened there because, frankly, I don't even know. I am not part of the investigation. I am not participating in it. But I said there were two problems there. One is that they got the accounting wrong. And they must have gotten some of it wrong because they took a huge restatement. But the worst problem is they may have gotten some of it right.

That to me is why the system has to be fixed.

My big concern is that the problems that we see in FASB did not arise with Enron. They have been around for the last 5 to 10 years, and nothing was done to fix it. We intend to fix it. If it is done by legislation, we are going to work with you and we will do what you want. But we cannot wait to fix FASB. We have to fix it immediately. It is broken and it has been broken for too long.

Senator CORZINE. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Mr. Chairman, thank you very much for coming. As you know, we are trying to get you a budget increase so you can address the pay parity issue, which I think is extremely important, particularly having promised people they were going to get pay parity, and now, not to deliver on that promise, it seems to me, is just going to significantly compound your morale problem at the SEC. You have enough challenges without starting to lose— or continuing to lose, I should more accurately say—extremely able and competent people.

We very much appreciate your being with us today.

Chairman PITT. Thank you.

Chairman SARBANES. The hearing is adjourned.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Chairman Sarbanes, thank you for holding today's hearing to discuss issues related to the oversight of the accounting profession, audit quality, and the formulation of accounting standards. Also, I thank Chairman Pitt for agreeing to speak with us today. I am sure that these are challenging times at the SEC, and I particularly appreciate your efforts to prepare for and attend today's hearing.

Today's hearing is the culmination of a series of 10 hearings that have enabled us to gain a thorough understanding of the pertinent issues. Mr. Chairman, I want to commend you for the constructive tenor of these hearings, and for allowing us to accomplish a great deal in a relatively short period of time.

As I have noted previously, the Enron Corporation debacle and other recent high-profile corporate bankruptcies represent a serious national scandal, one with terrible human and financial cost. Concern about audit and accounting practices have dogged many of these business failures. Furthermore, these accounting woes appear to be widespread, as is evidenced by the recent increase in the number of earnings restatements precipitated by accounting problems.

These developments have shaken the financial markets and left lingering doubts in the minds of investors about the integrity of the individuals and firms responsible for providing honest and unbiased financial information. We in Congress need to make sure that regulators and industry participants implement changes to address these issues.

The most obvious way to make progress is to give the SEC the personnel and the financial resources it needs to take strong enforcement measures against illegal accounting practices. I was disappointed that President Bush failed to provide these resources, even though the Congress spoke with one voice last year in passing H.R. 1088. As a member of the Senate Appropriations Committee, I will fight for these resources so we can have a strong and effective SEC to protect our capital markets.

Another important avenue for accomplishing this goal is through constructive and targeted legislative reforms.

I am very proud to join with Senators Dodd, Corzine, Stabenow, and others in cosponsoring a bill to address the problems that have become evident in audit and accounting practices at publicly-traded firms. S. 2004, the Investor Confidence in Public Accounting Act of 2002, tackles these problems by creating a framework to give investors access to transparent, accurate, and unbiased financial information crucial ingredients for the proper functioning of our free market economy.

The bill provides improved oversight of the auditing profession by establishing an independent regulatory organization that would be responsible for establishing audit standards, maintaining proper quality control oversight, and ensuring proper enforcement of violations. S. 2004 would also designate a fully independent organization to set generally accepted accounting principles. In addition, the bill clarifies auditor independence standards and provides for greater transparency in financial disclosures.

I would note, however, that these provisions should not materially affect small accounting firms or businesses that rely small accounting firms. Since the bill pertains primarily to accounting firms that conduct work for publicly-traded businesses, small businesses will be largely unaffected. I continue to be very concerned about the effect that any piece of legislation would have on small, Main Street businesses. I will continue to work to ensure that any legislation of this type protects the ability of small firms to compete in the marketplace.

I thank Chairman Pitt for his extensive and thoughtful written testimony, and I once again thank you, Mr. Chairman, for scheduling this hearing.

PREPARED STATEMENT OF HARVEY L. PITT

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

MARCH 21, 2002

Chairman Sarbanes, Senator Gramm, Members of the Committee: I am pleased to appear before the Senate Banking Committee on behalf of the Securities and Exchange Commission. As the final witness in the series of hearings you have held over the past 2 months, I have followed with great interest the many issues this Committee has explored surrounding high profile business failures in recent years, including, most recently, the collapse of the Enron Corporation. At the outset, Mr. Chairman, I would like to express how much my fellow Commissioners, our staff, and I appreciate the thoughtful and deliberative approach you have taken in these hearings. The record these hearings have developed will help us all advance our thinking on improvements to our current regulatory system and surely will be a landmark example for future Congresses to follow. Undoubtedly, the record compiled will provide a thorough foundation for making our Nation's Federal securities laws more responsive to the current-day needs of investors, whether by legislation, regulation, or some combination of the two.

On a related note, we want to thank you, Mr. Chairman, Senator Gramm, and all the Members of this Committee for your strong, bipartisan support of our agency. This Committee, of course, has had a long tradition of supporting the SEC; but over the last several months, as we have witnessed not one but three separate crises affecting our capital markets, you have provided leadership and strong support for our efforts, and I am personally grateful for your wisdom, support, and encouragement. In addition, we deeply appreciate the support of the entire Committee for funding pay parity for our staff and your concern for our agency's resources at this especially critical time. I will address resources later on in my testimony, but I wanted to begin a substantive discussion by both commending and thanking you, Chairman Sarbanes, Senator Gramm, and the Members of the Committee, for your extraordinary support.

INTRODUCTION

The past 7 months have tested the mettle and resiliency of our country, our markets, and the investing public's confidence. With the events of September 11, the bankruptcy of Enron and, just last week, the indictment of Arthur Andersen, we have witnessed how critical our appropriately vaunted capital markets are to the strength, security, and spirit of our country and our economy. All Americans have felt, and continue to feel, the consequences of these events. These hearings appropriately address the crisis created by the implosion of Enron Corporation. But before we turn to Enron's impact, it is important to keep in mind that, from the perspective of the Federal securities laws, all three crises have much in common. In each, the continuity and integrity of our capital markets was, or is, put in play. The response to the tragic loss of lives, and the sudden shutdown of our capital markets after the terrorist attacks of September 11, presented a model for all of us, and the rest of the world, on how to address and respond to a crisis. From the President's unstinting and fearless leadership, to bipartisan cooperation in the Congress, we responded quickly and forcefully to an unthinkable crisis. With the implosion of Enron, and the indictment of Arthur Andersen, my hope is that we will follow the model set last September, and work constructively together to restore vital confidence in our capital markets.

With Enron's disintegration, innocent investors, employees, and retirees, who made life-altering decisions based upon a stock's perceived value, found themselves locked-in to a rapidly sinking investment that ate up the fruits of years of their hard work. It is these Americans, whose faith fuels our markets, whose interests are, and must be, paramount. America's investors are entitled to the best regulatory system possible. The Commission as an institution, and I both as its Chairman and personally, are committed to doing everything in our power not only to prevent other abuses of our system, but also to improve and modernize our existing system.

In the aftermath of Enron's meltdown, our agency currently is conducting an enforcement investigation to identify violations of the Federal securities laws that may have occurred, and those who perpetrated them. Until the investigation is complete, the Commission cannot address the specific conduct of Enron Corporation and those involved with it, or the activities currently under investigation. The public can have full confidence, however, that our Division of Enforcement is conducting a thorough investigation and that the Commission will redress any and all wrongdoing and wrongdoers swiftly and completely.

Nothing that has occurred in recent months should undermine, or be allowed to undermine, investor confidence that our markets, or the regulatory system governing them, are still the best in the world. Our capital markets are still the world's most honest and efficient. Our current disclosure, financial reporting and regulatory systems also are still the best developed, the most transparent, and the best monitored by market participants and regulators. No other system yet matches the depth, breadth, and honesty of our markets, and it is important that we not lose sight of that critical fact. While some foreign regulators have publicly claimed that Enron would not have collapsed under other systems, I tell you unequivocally that any such claim is unsupportable.

But even though our system is the best at present, we can, and must, do better. As more and more individuals become direct participants in our markets, and face increasingly difficult investment decisions that affect their lives, savings goals and retirement security, we need to maximize the utility of our existing system for individual investors. At the same time, we must find a way to facilitate and promote the ability of American businesses to raise capital efficiently and expeditiously.

At my confirmation hearing before this Committee last July, I noted that our core securities laws are nearly 70 years old and reflect a time and state of technology long past. I promised to lead a review of the requirements the SEC administers to be certain they are sound, reasonable, cost-effective, and promote competition. At that hearing, many Members of this Committee, including Chairman Sarbanes and Senator Gramm, discussed with me the need for reform in the areas of corporate disclosure, accounting, analysts, and even crisis management. The events that have occurred since then have focused national attention and scrutiny on these needs. But as you are all well aware, the need for comprehensive reform in these areas did not arise overnight. In fact, this Committee had identified many of the issues with which we are now grappling even before I was confirmed. It is important to keep in focus the fact that our system has long needed regulatory attention, especially as we evaluate competing claims for solutions to currently perceived problems.

At my confirmation hearing, Senator Dodd gave me wonderful and sage advice. He said:

> [Y]our job is not to become the most popular guy in town. It is to be the guy that actually will look at us and tell us, when we may be calling on behalf of constituent interests, no matter how popular it may be, that you have an obligation to do what is really right on behalf of investors in this country, the consuming public that depends upon the integrity of these markets. . . . [A]t the end of the day, you have to decide—the Commission does—what is really in the best interest of maintaining those basic pillars and standards that have . . . sustained this country and its markets and their integrity for so long.

I am reasonably confident that I have already satisfied and surpassed Senator Dodd's first standard—clearly, I am not "the most popular guy in town!" Today, I address Senator Dodd's second guiding principle—I will tell you what we think in unvarnished fashion.

OPERATIVE PRINCIPLES

In dissecting the weaknesses Enron has highlighted, and exploring appropriate solutions, we should start by recognizing the substantial agreement and consensus that exists. We all know there are problems. Enron will stand in history as the symbol of the excesses of the 1990's, when our markets lived on a culture of speculation, with too many market participants believing the market could only go up. Enron is the poster child for something that has been evident for a long time—our financial disclosure and reporting system has not kept pace with changes in our markets, and as a result, it does not work as well as it should. Enron is tragic, and we grieve for the losses investors and employees suffered. Enron also must be a catalyst for lasting reform.

In analyzing the aftermath of Enron, there are two discrete issues we must address, and concomitantly, two discrete attributes the solution to both issues must possess. First and foremost, it is no secret that the public's confidence in our capital markets and disclosure system has been shaken over the past 7 months. Therefore, whatever it is that we do, we must do it quickly. Second, our system of financial disclosure and reporting, corporate governance and accounting regulation are in need of significant improvements and updating. Therefore, as we act quickly, we must also act wisely and comprehensively.

As we work together, we need to identify the problems requiring solution, discuss the range of proposed solutions, consider alternatives to, and criticisms of, those al-

ternative solutions, and accept the timeless truth that, in matters of this nature, there are no perfect answers, there is no absolute truth. Indeed, to paraphrase both Voltaire and von Clausewitz, the worst enemy of a good solution is a perfect one.[1] Both Congress and the Commission must act—at the Commission, through regulation, which has the benefit of greater immediacy, pursuant to our existing and ample available authority; in the Congress, through legislation, which has the benefit of extending the reach of our available authority where necessary. The fact that we have ample authority to pursue most of our reform objectives does not lessen our obligation to consult and work with Congress. But it does mean that Congress should be cautious in passing legislation unless it is clear that our authority simply cannot get us to the finish line. Together, I am confident that we can solve these problems in the best interest of the public.

Regardless of the reforms we discuss or adopt, one point must be absolutely clear. The Commission and our Division of Enforcement are vigorously engaged in enforcing the current securities laws. Make no mistake, the SEC is the markets' top cop and—with additional resources this Committee has sought for us—we will carry out our mission with even greater vigor.

OVERVIEW OF NEEDED REFORMS

Our system requires that corporate leaders be faithful to the interests of investors and to act with both ability and integrity. Complete and accurate disclosure and financial reporting to investors and markets are important parts of this duty. The most important challenge to corporate governance today is to restore the preeminence of this duty. This is as much a moral imperative as a legal one.

In recent years, corporate leaders have been under increasing pressure from the investment community, including individual investors, to meet elevated expectations. They also have been operating under a system that can misalign the incentives of investors and those of management. Our culture over the past decade has fostered a short-term perspective of corporate performance. Corporate leaders and directors have been rewarded for short-term performance, sometimes at the expense of long-term fundamental value. Investors have purchased stock not because they believed in the business or its strategy as an investment over the long-term, but simply under the assumption that stock prices would only go up.

But after a most incredible bull market, we have had to witness the truth of the timeless axiom that whatever goes up can also come down, and not only because of a reversal in business outlook or fundamentals. Corporate leaders, under pressure to meet elevated expectations in the bull market, in too many instances were drawn to accounting devices whose principal effect was to obscure potentially adverse results. Moreover, the effectiveness of a number of the checks and balances intended to ensure that we achieve appropriate corporate governance and financial reporting and disclosure also declined. These include reviews of financial reporting by outside auditors and the activities of audit committees. The moral imperative on those intended to provide the checks and balances has eroded and must be restored. Out of the ashes of the Enron debacle, corporate reputation is reemerging as a significant economic value. Corporate governance appears to be improving as a result of this greater market discipline in the wake of the Enron debacle. But much more needs to be done.

Confidence in our capital markets begins with the quality of the financial information available to help investors decide whether, when and where to invest their hard-earned dollars. Comprehensible information is the lifeblood of strong and vibrant markets. Our system and the global markets supporting that system require accurate, complete and timely disclosure of financial and other information. The current system of Federal securities regulation is premised on full and fair disclosure of this information. Companies choosing to access the public capital markets must provide material information about their financial results and condition, businesses, securities, and risks associated with investment in those securities.

This Committee and its distinguished predecessors wisely permeated the Federal securities laws with the philosophy that full disclosure is the best way to permit markets to allocate capital. Congress rejected a "merit-based" system of regulation, which could have been construed as Government's approval or guarantee of securities issued by public companies and that could unduly interfere with efficient market allocation of capital. Optimal capital allocation requires that there not be limits on entrepreneurship or companies failing, or on permitting people to invest in com-

[1] Francois Marie Arouet Voltaire, *Dictionnaire Philosophique,* "Le mieux est l'ennemi de bien" ("Perfection is the enemy of the good"). *Compare also* Carl von Clausewitz, *On War* ("The greatest enemy of a good plan is the dream of a perfect plan.").

panies that will fail. There must, however, be complete, clear, and timely disclosure to support the market's allocation decisions. We believe it is important to maintain a disclosure-based regulatory system that relies on capital allocation decisions made by market participants.

The success of our markets has not been due just to their depth and breadth, but also to their quality and integrity. In the wake of the Great Depression, when world economic forces caused precipitous and calamitous declines in equity market values, this Country learned that investors are willing to commit their capital to markets only if they have confidence that those markets are fairly and honestly run, are fully transparent, and affirmatively minimize the risk of loss from fraud and manipulation. Existing statutory and regulatory provisions require that the public statements by or on behalf of publicly-traded companies in the United States contain no misstatements of material fact and no omissions that make the statements that are made materially misleading. These protections are supported by a detailed structure of accounting and disclosure requirements intended to ensure that financial reporting and other disclosures meet the mandated standards of accuracy, completeness, and comparability. Current law prohibits wrongful activity including, but very definitely not limited to, fraud in making materially defective or incomplete disclosure.

As the complexity of our financial markets continues to grow unabated, and the number of Americans who participate in them increases steadily, the Commission must ensure that our system's traditional high standards are not compromised. The goal of the SEC is to ensure that our financial markets are transparent and fair to all investors, and to do so, we must make certain that the public is adequately informed about investing and that corporate America provides the disclosure investors need to make fully informed decisions based on sound and reliable information. In addition to our extensive investor education programs, an integral part of our investor protection efforts is the SEC's aggressive law enforcement program, which protects investors from fraudulent and unfair practices.

Of course, no one should believe that we could create a foolproof system; those with intent and creativity can override any system of checks or restraints. Fraud aside, however, both the quality and timeliness of financial reporting and other disclosures can, and must, be enhanced. Financial reporting and disclosure standards can and should be amended to address the evident deficiencies, and the standard setting process can and should be made more responsive to changing circumstances. As I discuss in more detail below, we believe we can achieve needed improvements by improving standards and our regulations in three principal areas.

- ***First, disclosure by public companies must be truly informative and very timely.*** Companies must be subject to an affirmative obligation to provide reliable information that is informative, relevant, comprehensible, and timely. Investors should have all the information they need to make valuation and investment decisions. We want investors to have an accurate and current view of the posture of their company, as seen "through the eyes of management." This has long been the SEC's disclosure standard, but "through the eyes of management" must be viewed by all of us, and most importantly by companies' top officials, as a broad and fluid obligation, not merely an obligation to disclose specified categories of information at specified times. And meaningful disclosure is more than a single number. There has been far too heavy an emphasis by all market participants on quarterly and on year-end earnings per share, and too little emphasis on a concise, yet lucid, presentation of financial information. We recommend additional substantive disclosure requirements that permit fuller understanding of financial statements and thereby improve overall financial disclosure. We also recommend improving other disclosure requirements to provide disclosure of higher quality, while avoiding greater quantity for quantity's sake. Finally, we are seeking to modernize our disclosure system to seek more timely disclosure of the most significant information, while protecting companies from premature disclosure, disclosure of sensitive information and second-guessing over when and how disclosures were made.
- ***Second, oversight of accountants and the accounting profession must be strengthened and accounting principles that underlie financial disclosure must be made more relevant.*** Outside auditors have an important role in ensuring that the companies they audit present an accurate, complete, and current picture of their financial condition. Critical regulatory functions, including quality control and discipline, should be moved from the profession to an independent regulatory body that is completely or substantially free from influence or funding by the profession, and is subject to comprehensive and vigorous SEC oversight. Standards of independence should be revisited and strengthened to prevent conflicts of interest that might cause auditors to compromise the performance of their auditing functions. The standard setting process for accounting and financial dis-

closure must be more timely and responsive to market changes and independent from undue influence. Present-day accounting standards are cumbersome and offer far too detailed prescriptive requirements for companies and their accountants to follow. That approach encourages accountants to "check the boxes"—to ascertain whether there is technical compliance with applicable accounting principles. We seek to move toward a principles-based set of accounting standards, where mere compliance with technical prescriptions is neither sufficient nor the objective. We support the wisdom of having accounting standards set by the private sector, but subject to our vigorous oversight. That standard setting authority today resides in the Financial Accounting Standards Board, whose pronouncements govern financial statements because, but only because, the Commission has chosen to accept those standards as authoritative. The SEC should exercise its authority to ensure that FASB's agenda is responsive to issues facing investors and accountants and is completed on a timely basis.

- ***Third, corporate governance needs to be improved.*** Recent events also underscore the need to craft responsible guidance for directors and senior officers to follow. There are a number of ways current corporate governance standards can be improved to strengthen the resolve of honest managers and the directors who oversee management's actions and make them more responsive to the public's expectations and interests. We think the best way to do that is a two-fold approach: First, make certain that officers and directors have a clear understanding of what their roles are, and second, apply serious consequences to those who do not live up to their fiduciary obligations. The role of audit committees and outside directors also must be strengthened.

In his State of the Union Address in January, the President appropriately demanded "stricter accounting standards and tougher disclosure requirements." He called for corporate America to "be made more accountable to employees and shareholders and held to the highest standard of conduct." [2] And just 2 weeks ago, the President outlined a substantive, serious, and thoughtful program to move toward implementation of these goals.[3] The SEC shares and embraces these principles, and is firmly committed to making them a reality.

OUR WORKING PROPOSAL

Even before Enron Corporation failed, we had been working to improve and modernize our corporate disclosure and financial reporting system to make disclosures and financial reports more meaningful and intelligible to average investors. As I pointed out in an opinion piece in *The Wall Street Journal* last December, the public and the private sectors must work hard, together, to produce sensible and workable solutions.[4] Effective and transparent private sector regulation of accounting and accountants, subject to both SEC oversight and rigorous review by Congress, is an essential component. In addition, it is critical to improve corporate disclosure with financial statements that are clear and informative, with a system of "current" disclosure of unquestionably significant information and with better identification and discussion of critical accounting principles and other financial information and their impact on a company's results.

The Commission has endeavored to move forward as quickly as it responsibly can on these issues. First, in cautionary advice on December 4, 2001, we gave guidance on the appropriate use of, and limits on, pro forma financials.[5] In further cautionary guidance issued on December 12, 2001, we set forth initial requirements and guidance on the obligation of public companies to disclose critical accounting principles.[6] On December 21, 2001, we announced that our Division of Corporation Finance would monitor the annual reports submitted by all Fortune 500 companies that file periodic reports with the Commission in 2002.[7] This new initiative significantly expands the Division's review of financial and nonfinancial disclosures made by public

[2] President George W. Bush, STATE OF THE UNION ADDRESS (January 29, 2002).

[3] President George W. Bush, REMARKS DURING 2002 MALCOLM BALDRIDGE NATIONAL QUALITY AWARDS CEREMONY (March 7, 2002); PRESIDENT'S PLAN TO IMPROVE CORPORATE RESPONSIBILITY AND PROTECT AMERICAN SHAREHOLDERS, available at *www.WhiteHouse.gov/infocus/corporate responsibility*.

[4] "How to Prevent Future Enrons" *The Wall Street Journal,* A18 (December 11, 2001), annexed as Attachment A.

[5] Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, Securities Act Release No. 8039 (December 4, 2001).

[6] Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Exchange Act Release No. 45149 (December 12, 2001).

[7] "Program to Monitor Annual Reports of Fortune 500 Companies," *SEC News Digest,* Issue 2001–245 (December 21, 2001).

companies. On January 17, 2002, we announced our preliminary plan for a Public Accountability Board, a private sector regulatory body for the accounting profession.[8] On January 22, we identified issues in Management's Discussion and Analysis to be addressed in 2001 fiscal year reports regarding off balance sheet financing arrangements.[9] On February 4, the securities industry and its self-regulators announced proposed rules to create more transparency for analyst recommendations—in response to a directive from the House Financial Services Committee and guidance from the SEC. We are in the process of obtaining public comments on these proposed rules and will proceed expeditiously to review and finalize them.[10] On February 13, we announced plans to propose rules to address aspects of corporate disclosure needing immediate improvement, and on the same day we called upon the New York Stock Exchange and Nasdaq to look at specific components of corporate governance.[11]

Just this Monday, we released orders and temporary rules in order to assure a continuing and orderly flow of information to investors and the U.S. capital markets in light of the indictment of Arthur Andersen LLP.[12] Immediately upon the announcement by the Department of Justice that Andersen had been indicted, we announced that we requested and received assurances from Andersen that it will continue to audit financial statements in accordance with generally accepted auditing standards and applicable professional and firm auditing standards, including quality control standards. Andersen has also told the Commission that if it becomes unable to continue to provide those assurances, it will advise the Commission immediately. The Commission will continue to accept financial statements audited by Andersen in filings as long as Andersen's assurances remain in full force and effect. The orders and rules we released also establish a framework for Andersen clients that are unable to obtain from Andersen, or that elect not to obtain from Andersen, a signed report on audits that are currently in process. As to those issuers, the Commission will require adherence to existing filing deadlines, but will accept filings that include unaudited financial statements from any issuer unable to provide audited financial statements in a timely manner. Issuers electing this alternative generally will be required to amend their filings within 60 days to include audited financial statements. This alternative framework is procedural in nature, is of finite duration, and is intended solely to address timing constraints and temporary disruptions that the affected issuers may face.[13]

Over the past several months, we have been seeking input broadly, from all concerned, on both corporate disclosure and auditor regulation. To that end, we held Roundtables, on March 4 in New York City and March 6 in Washington, DC, with distinguished business executives, lawyers, accountants, academics, regulators, and public interest representatives, who discussed various proposals and helped advance our understanding and insight into these issues. We have scheduled our next Roundtable for April 4, in Chicago, and plan to hold additional Roundtables in the next 2 months. This May, we will hold our first ever "Investor Summit" to solicit additional investor input.

This Committee has acted in a similar manner, seeking input from a wide variety of experts, and today both the Commission and this Committee are much better informed as a result of our respective information-gathering processes. For example, the "Investor Confidence in Public Accounting Act" recently introduced by Senators Dodd and Corzine has substantially advanced the discussion of issues in the area of regulation of public accounting in this country. Other related initiatives contain a number of suggestions that would be beneficial to the overall improvement of our system and its controls in the wake of Enron.

In testimony today, we seek to offer this Committee the most detail we can on our thoughts and plans for reform. But we do not yet have final answers. We are still soliciting and gathering additional broad input. We are receiving e-mails, phone

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[8] Public Statement by SEC Chairman Harvey L. Pitt: Regulation of the Accounting Profession (January 17, 2002), available at *www.sec.gov/news/speech*.

[9] Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations (January 22, 2002), available at *www.sec.gov/rules/other*.

[10] *See* Notice of Filing of Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 45526, File Nos. SR–NASD–2002–21; SR–NYSE–2002–09 (March 8, 2002).

[11] The Securities and Exchange Commission's Press Releases regarding these actions are annexed as Attachments B–H.

[12] Requirement for Arthur Andersen LLP Auditing Clients, Securities Act Release No. 8070 (March 18, 2002).

[13] The Commission's Press Release regarding reporting requirements for companies audited by Andersen LLP is annexed as Attachment I.

calls, and letters daily from a wide variety of our constituents. We are continuing to work with this Committee, the Congress, the Justice Department, the Labor Department, and the President's Working Group on Financial Markets. Of course, we will invite additional public comments in the formal rulemaking process. Therefore, I respectfully submit this testimony today as our informed commentary on a number of important and complex subjects, but caution that it is truly a work in progress—we are ready to learn more, to explore further, and we will not foreclose any valuable alternatives and suggestions. The SEC does not have a monopoly on wisdom. What we do have is an undeniable obligation to think about the issues, search for answers, lead constructive debate, and move quickly on behalf of investors.

1. Corporate Governance and Disclosure Reforms

One of the most important challenges facing our capital markets today is to improve the quality of available corporate information. While technology enables investors to acquire information more rapidly than ever, our capital markets cannot reach a higher level of efficiency and investor confidence unless companies provide higher-quality, more insightful information as well.

As we engage in rulemaking efforts to strengthen the corporate disclosure system, the Commission also is assessing how our staff can further protect investors through our review of that disclosure. In recognition of the limits of our resources, we are working to further the application of risk management techniques to our review process. For example, in the screening of periodic reports by the Fortune 500 companies that we have begun, we are using revised criteria which focus on areas we believe require in-depth scrutiny. Some of our additional personnel resource requests are intended to enable us to build an improved risk management competence for many facets of our agency's activities, not the least of which is corporate disclosure.

1.1 Improved Quality of Financial Disclosure

1.1.1. Management's Discussion and Analysis

Among other reforms, we believe it is necessary to improve the Management's Discussion and Analysis section of disclosure documents. MD&A has three related objectives:

- To provide a narrative explanation of companies' financial statements to enable investors to see the company "through the eyes of management."
- To improve overall financial disclosure and provide the context within which financial statements should be analyzed.
- To provide information about the quality of, and risks to, a company's earnings and cashflow.

As such, MD&A is the backbone of a company's disclosures. Its goal is to wrap GAAP financial statements in a clear, understandable discussion of their context. Recognizing the importance of MD&A information to investors, the Commission is working to improve the quality of that disclosure in three key ways.

- Critical Accounting Policies

First, we intend to propose that companies be required to identify critical accounting policies—that is, the accounting policies of a company that are most important to the presentation of its financial condition and financial results and that require the most subjective or complex accounting estimates. Investors need a greater awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. In our December 12, 2001 release, we have asked companies to begin addressing that need.[14] We intend to adopt new rules to elicit more uniform and precise disclosures about critical accounting policies in the MD&A section of annual reports, registration statements, and proxy and information statements, with quarterly updates of that disclosure.

Although, we are still formulating our precise critical accounting policies rules, it is already manifest they should include, at a minimum, basic disclosures investors need to understand how a company identifies those policies, and a discussion of those policies in the context of the company's financial results, explaining which accounting estimates and assumptions relate to them. Investors will benefit from knowing what uncertainties could affect those estimates and assumptions. Simple quantitative analysis could show investors the sensitivity of a company's estimates, and the impact on a company's financial statements of possible changes—both positive and negative—of those estimates. Past changes a company has made in estimates may be relevant, as well as disclosure of any trends or uncertainties that may cause a company to change the accounting method it uses. Investors also should

[14] This release is annexed as Attachment C.

know whether management discussed the selection, application, and disclosure of the critical accounting policies with the audit committee of the board of directors. Finally, to be truly useful, any new disclosure about critical accounting policies must be clear, concise, and understandable—not legalese or "accountingese."

- SPE'S AND RELATED PARTY TRANSACTIONS

Investors have become increasingly interested in the sufficiency of disclosure regarding off balance sheet obligations and contingencies, including use of special purpose entities. A company's relationships with unconsolidated entities facilitate its transfer of, or access to, assets. Investors need to know more about liquidity risk, market price risks, and effects of "off balance sheet" transaction structures. MD&A should mandate specific disclosures by companies concerning transactions, arrangements and other relationships with these unconsolidated entities, or other persons, when they are reasonably likely to have a material effect on a company's liquidity, its capital resources or its requirements for capital. If a company's liquidity is dependent on the use of off balance sheet financing arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities, investors also need to know the factors that are reasonably likely to affect its ability to continue using those off balance sheet financing arrangements. Such matters could affect the extent of funds required within management's short- and long-term planning horizons. The Commission will clarify the need for this type of information in MD&A.[15] As indicated in our February 13 press release, we also intend to propose rules requiring current disclosure of transactions that increase a company's obligations, including contingent obligations, whether or not reflected on its balance sheet.[16]

Many readers of financial statements also have cited a lack of transparent disclosure about transactions where that information appeared necessary to understand how significant aspects of the business were conducted. The investors would better understand financial statements in many circumstances if companies' MD&A disclosures included descriptions of the terms of broader categories of material transactions that differ from those that likely would be negotiated with the clearly independent parties, whether or not they involve "related parties" as traditionally defined. Investors need to understand a transaction's business purpose and economic substance, its effects on the financial statements, and the special risks or contingencies arising from it. More specific MD&A requirements relating to the effects of these kinds of transactions would aid investors.

- TREND INFORMATION

The third phase of our MD&A rulemaking will improve MD&A disclosures relating to trend information. We believe investors will be better able to see a company through management's eyes if MD&A includes information about the trends that a company's management follows and evaluates in making decisions about how to guide the company's business. This disclosure would in many cases entail certain forward-looking information. Thus, with the envisioned improvements in companies' financial trend disclosure, we will need to address lingering issues relating to when a company needs to update disclosure that is forward-looking and viable in the marketplace. With expanded disclosure obligations, we also are mindful of the liability issues and the liability standards associated with new disclosures. Our goal is to assist investors by providing more meaningful and understandable information, but not to convert our disclosure system into an attractive nuisance for increased litigation.

1.1.2. Clarity and Accountability

In addition to these planned MD&A disclosure reforms, we have in mind two very different initiatives, both of which would improve the quality and the utility of the corporate disclosure system. These are still in the conceptual planning stage.

First, we believe investors would benefit if companies could produce clear and concise financial statements. This would *not* be an initiative to "dumb down" or omit the complete picture that current financial statements are intended to provide. Rather, it would be an effort to give companies the flexibility to produce and disclose financial information in "layers" ranging from those with a general "big picture" focus to those that encompass the minutest detail, all of which would be readily accessible to investors electronically. This would permit investors to "drill down" to whatever layer they wish. The layers would allow companies to explain financial

[15] *See* Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations (January 22, 2002), available at *www.sec.gov/rules/other.*

[16] The Commission's Press Release regarding these rules is annexed as Attachment G.

statement disclosure to investors in ways that are more clear, concise, and understandable.

The second initiative is to improve the corporate disclosure system by increasing the CEO's individual accountability for his or her company's disclosure. As the President noted in his March 7 speech on corporate ethics and disclosure,[17] it is unacceptable for the CEO of a company to disclaim responsibility for, or deny awareness or understanding of, the financial disclosures that his or her company makes. We are committed to addressing and reinforcing that responsibility. Our vision is a rule that would require CEOs' to certify to shareholders that any significant information of which the CEO is aware has been disclosed to shareholders, and that the disclosures made are not misleading, inaccurate, or false. We believe this "sign on the dotted line" approach will focus CEOs' attention very acutely on responsibilities that already exist under current law. We are also considering rulemaking that would call for the establishment of procedures designed to bring significant information to the attention of top management.

1.2. More Timely Disclosure

In addition to improving MD&A and other initiatives to improve the quality of the corporate disclosure system, we also intend to take other steps to modernize and improve the timeliness of corporate disclosures. We are working on three sets of proposed rules that would do this.

1.2.1. Accelerated Annual and Quarterly Reports

We are considering proposing rules that would shorten the filing deadlines for annual reports from 90 to 60 days after a company's fiscal year end and would shorten the filing deadlines for quarterly reports from 45 to 30 days after a quarter's end. The current secondary market disclosure system under the Exchange Act requires companies to provide updated information to investors at annual and quarterly intervals, with a small number of specified significant events reported somewhat more timely. The SEC has not changed its annual and quarterly report deadlines for more than 30 years. Thirty years ago, the companies still were dependent on paper and pencil, adding machines, carbon paper, and the U.S. mails to prepare and file their reports with us. Significant technological advances in the intervening decades, including computers, remarkably quick and sophisticated financial and other software, speed-of-light communications, e-mail, video conferencing and the like, have enabled companies to capture, communicate, and evaluate information and prepare their reports more rapidly.

The revolution in information technology and communications that allows companies to disseminate and collect information broadly and swiftly also has both increased investors' demand for, and provided the means for companies to supply, corporate disclosures on a more "real time" basis. Many public companies have adopted the practice of routinely issuing press releases to announce their annual and quarterly results *significantly in advance* of the due dates for their Exchange Act reports.[18] This is concrete empirical evidence that a more rapid time line for corporate disclosures is feasible and achievable. For all of these reasons, it is long overdue for us to modernize our periodic reporting system by significantly shortening report deadlines. The Commission for years has recognized the critical need for such reform.[19] We are committed to implementing those reforms.

1.2.2. More Accessible Filings

Today, the first and most obvious resource for many investors trying to find information about a company is through that company's website. We want to assure that investors can find companies' reports there. We therefore intend to move toward a system where public companies with Internet websites will post their periodic reports there no later than the same day they are obligated to file reports with the Commission.

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[17] President George W. Bush, REMARKS DURING 2002 MALCOLM BALDRIDGE NATIONAL QUALITY AWARDS CEREMONY (March 7, 2002); PRESIDENT'S PLAN TO IMPROVE CORPORATE RESPONSIBILITY AND PROTECT AMERICAN SHAREHOLDERS, available at *www.WhiteHouse.gov/infocus/corporateresponsibility.*

[18] Of course, there can be problems in such releases, especially in the presentation of "pro forma" earnings, which caused the Commission to issue its cautionary guidance on December 4, 2001. Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, Securities Act Release No. 8039 (December 4, 2001).

[19] *See* The Regulation of Securities Offerings, Securities Act Release No. 7606A (November 13, 1998), Sections XI.A–XI.B.

1.2.3. Accelerated Disclosure of Corporate Insiders' Trading Activities

Under current law, corporate insiders are not required to file reports of their trading activities with the Commission until 10 days after the end of the month in which the trading occurred.[20] Six years ago the Commission adopted a rule that allows insiders who sell their holdings back to their companies to postpone disclosure of those transactions for up to an additional year.[21] Under current law, we cannot accelerate statutory reporting requirements applicable to insiders. But we can and intend to impose obligations on *companies* to report immediately any transactions by corporate insiders, including those with the company. Legislation is currently pending that would amend Section 16 of the Exchange Act to require the reporting (by electronic media) of securities transactions by officers, directors, or other affiliated persons of the issuer within a much shorter time frame (a business day or two). While there are practical issues to work through regarding electronic filing, the concept of requiring insiders to report their trades more expeditiously is unassailable. Legislation of this nature is worth consideration, but we do not think it is critical. We intend to act by rule in order to expedite the flow of this important information to the market.

1.2.4. More Current Disclosure

We also intend to solicit public comments soon on a significantly expanded list of items to be disclosed by companies between their current periodic reporting periods. In addition, we intend to accelerate the filing deadline for these disclosures. At present, only five corporate events trigger mandated intra-period disclosure on Form 8–K. These include a change in the company's independent auditor; resignation of a director; a change in control; the acquisition or disposition of a significant amount of assets not in the ordinary course of business; and bankruptcy or receivership.

The proposals being drafted would add approximately a dozen new significant events requiring companies to make expeditious Form 8–K filings. In addition to transactions by insiders in company securities, described above, companies would be required to report the following events on a current basis:

- Changes in rating agency decisions about a company.
- Defaults and other events that could trigger acceleration of direct or contingent obligations.
- Transactions that result in material direct or contingent obligations not included in a prospectus filed by the company with the Commission.
- Offerings of equity securities not included in a prospectus filed by the company with the Commission.
- Waivers of corporate ethics and conduct rules for officers, directors, and other key employees.
- Material modifications to rights of security holders.
- Departure of the company's CEO, CFO, COO, or president.
- Notices that reliance on a prior audit is no longer permissible, or that the auditor will not consent to the use of its report in a Securities Act filing.
- Definitive agreements that are material to the company.
- Losses or gains of material customers or contracts.
- Material write-offs, restructurings or impairments.
- Movement or de-listing of the company's securities from an exchange or quotation system.
- Any material events, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans.

Under existing Form 8–K requirements, companies must file a Form 8–K within 5 business or 15 calendar days after the triggering event, depending on the nature of the event. Given the significance of these disclosures to participants in the secondary markets, we intend to propose that companies be required to file their Form 8–K reports no later than the second business day following occurrence of the events. We also will consider whether some of the events should be disclosed by the opening of business on the day after the occurrence of the event. The need for more current disclosure of a broader range of significant corporate activities is something the Commission recognized several years ago.[22] We are committed to having companies provide better current information.

Over a longer term, we also will consider amendments to the basic framework of the reporting system to require public companies to disclose vital information on a

[20] Section 16(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78p(a)).

[21] *See* 17 C.F.R. 240.16a–3(f) and 16b–3(e), adopted by Exchange Act Release No. 37260 (May 31, 1996).

[22] *See* Securities Act Release No. 7606A (November 13, 1998), Section XI.B.

"current" basis. We intend to formulate revisions to our rules that would impose a duty on companies quickly to disclose events that are unquestionably significant to investors. This would include, but not be limited to, the updating of the trend information that we envision adding to the MD&A disclosure requirements.

1.3. Corporate Governance Reforms

As discussed, there are a number of ways current corporate governance standards can be improved to strengthen the resolve of honest managers and the directors who oversee management's actions and make them more responsive to the public's expectations and interest. In considering these reforms, it is important to keep in mind that, traditionally, corporate governance issues and standards have been left to the States to develop and enforce. We do not recommend a change in that basic division of responsibilities between the States and the Federal Government. Nonetheless, because our markets are national and international, not solely intrastate, and because the consequences of a lack of meaningful and cohesive corporate governance reform are dramatic, we are devoting considerable attention to the ways in which our system can be improved. Other witnesses have raised similar concerns.[23] We support the "race to the top" of best practices on corporate governance.

To this end, last month we asked the New York Stock Exchange and Nasdaq to review their corporate governance and listing standards, including important issues of officer and director qualifications and codes of conduct of public companies. We also separately asked Financial Executives International to review its code of ethics in light of recent developments. Both the NYSE and Nasdaq responded quickly to our requests. Both have commenced reviews of existing requirements, and have appointed committees to assist that effort. We expect to receive results of their reviews shortly. And, this past Tuesday, FEI presented us with a series of recommendations, as well as revisions to its acclaimed code of ethics.[24]

We also intend to implement the President's directive to us to require CEO's to certify their company's annual and quarterly filings in a meaningful way. As we envision this, we believe that CEO's should be able to attest to the fact that anything *they* consider important in running their companies has been disclosed to investors. In addition, the President called upon us to seek disgorgement from corporate officers and directors of compensation and bonuses predicated on corporate performance that turns out to have been illusory or fraudulent. In fact, on March 13, we filed an action seeking exactly such disgorgement from the former president and chief operating officer of IGI, Inc. for violations of the antifraud, periodic reporting, recordkeeping, internal controls and lying to auditors provisions of the Federal securities laws.[25] We intend to proceed similarly in other appropriate situations where principal corporate officers and directors can disgorge to investors and their companies unearned or undeserved bonuses, stock options, and compensations.

1.4. Capital Raising Reforms

Finally, contemporaneous with this renewed focus on the corporate disclosure system, we will pursue our plan to implement long-needed reform in the regulations governing capital raising. Our capital markets need to be strengthened by revising many of the communications restrictions imposed under the Securities Act and its regulations and by modernizing the delivery system for information, including prospectuses. In addition, once the Commission truly has put in place a current disclosure system, it will then be both possible and appropriate to provide accelerated access to the public markets for seasoned reporting companies with the largest market capitalization.

These offering initiatives remain a priority and the work on them is well underway; they should go hand-in-hand with some of the other initiatives I have already mentioned. In prior years, the Commission recognized the need for this kind of reform, but did not implement these improvements.[26]

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[23] *See, e.g.,* Senate Banking Committee testimony of John Whitehead on March 19, 2002 ("The authority of the SEC should also be extended to create a new self-regulatory entity charged with drafting a voluntary code of best corporate governance practices linked to an SEC disclosure requirement. Companies would then disclose whether they comply with the voluntary code, and explain areas of noncompliance.").

[24] The FEI's recommendations and revised code of ethics are annexed as Attachment J.

[25] *See* SEC Files Financial Fraud Actions and Settled Administrative Proceedings Against Former Senior Officer and Managers of IGI, Inc., and Against IGI, Inc., Litigation Release No. 17410 (March 13, 2002). The action is pending.

[26] *See* Securities Act Release No. 7606A (November 13, 1998), *See also* Report of the Advisory Committee on the Capital Formation and Regulatory Processes (July 1996).

1.5. Legislative Assistance

I have highlighted some of the items on the Commission's agenda for improving the quality and timeliness of corporate disclosures and modernizing the offering process. There are a few areas where we believe we need the assistance of Congress to implement fully some of the initiatives I have discussed, and to take other important steps in improving the integrity, quality, and timeliness of the corporate disclosure system.

1.5.1. Additional Enforcement Tools

As noted, the President has called upon us to improve the system of personal accountability for corporate disclosures on the part of corporate officers and directors. The President also endorsed our need for administrative authority to bar officers and directors who seriously violate their duties to public shareholders. At present, the securities laws authorize us to seek officer and director bars in court in appropriate cases.[27] But some courts have taken an inhospitable approach to the plain legislative language, thwarting our ability to prevent some officers and directors who inflict serious harm on investors from repeating that kind of conduct.[28] We will continue to press for a more enlightened and hospitable reading of the statutory language, but we believe the Commission should have the ability, administratively, to effect such relief promptly, subject of course to subsequent judicial review of the Commission's action. We also think the Commission should have the authority to impose penalties in these instances. By removing existing judicial restraints, and by providing for judicial review of the Commission's imposition of such a sanction, you will be giving us a tool we need to address and deter corporate malfeasance and misfeasance—akin to our authority to do the same with brokerage firm personnel, stock exchange officers, directors and others, akin to the authority of the banking regulators to bar future service by banking officers and directors. A recent edition of *Business Week* reported that a significant majority of the chief financial officers polled by *Business Week* and the Financial Executives International favored harsher penalties for officers and directors who fail to discharge their duties properly.[29]

In addition, as I noted during my confirmation hearings, the amount of recidivism in the securities field is alarming. We believe that both the Commission and the courts should be under an *obligation* to impose officer and director bars in any case of repeat fraudulent misconduct by officers and directors.

Another tool we seek to enable us to deal with recidivists is statutory flexibility for the Commission to seek civil contempt penalties for those who violate prior judicial or administrative sanctions and restrictions. The Commission believes that the Department of Justice also should be given the ability and the resources to pursue instances of criminal contempt, on its own or at the Commission's urging, with a simplified statutory test that will not bog these cases down in endless proceedings.

Under existing law, the civil liability provisions for violation of disclosure requirements include disgorgement of all gains, but for those without gains the maximum civil liability is $120,000 or the "gross amount of pecuniary gain" for each violation, even for fraudulent disclosure violations. We seek legislation that increases the sanctions for defective disclosure. Legislation was passed in 1984 to address the previously insufficient sanctions under the securities laws for insider trading.[30]

A similar need exists today to increase the sanctions for violation of disclosure requirements without regard to trading. Investors can be harmed by disclosure that violates applicable requirements to the same degree, whether or not those responsible for the violations are trading. Since the purpose of these sanctions is to deter future misconduct, and redress past misconduct, looking at this problem from the vantage point of defrauded investors is the appropriate approach. While large monetary sanctions will not, by themselves, rid us of misconduct, they will give all those involved in our capital markets a greater incentive to abide by the statutes and rules administered by the SEC.

1.5.2. Increased Emergency Powers

On November 13, 2001, the House of Representatives passed H.R. 3060, the Emergency Securities Response Act of 2001, to augment the emergency authority of the

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[27] Section 21(d)(2) of the Securities Exchange Act.

[28] *SEC* v. *Patel,* 63 F.3d 137, 141 (2d Cir. 1995) (in reversing the lifetime injunction against an officer of a company who was found to have violated the Federal securities laws, the court discussed a nonexclusive six factor test for considering fitness to serve as officer or director: (1) the egregiousness of the violation; (2) whether the defendant was a recidivist; (3) the defendant's position when he engaged in the fraud; (4) the degree of scienter; (5) the defendant's economic gain from the violation; and (6) the likelihood that the defendant would repeat the misconduct).

[29] "The CFO's Weigh in on Reform," *Business Week* (March 11, 2002).

[30] *See* Insider Trading Sanctions Act of 1984, Pub. L. 98–376, 98 Stat. 1264.

SEC by revising Section 12(k) of the Exchange Act, to allow emergency powers for 30 business days. We had found, in the wake of the business repercussions from the significant damage and loss of life inflicted on lower Manhattan following the horrific events of September 11, that the existing provision of 10 business days was not sufficient. I commend this legislation to the Committee's attention and ask for your support to present such legislation to the Senate.

1.5.3. Increased Shareholder Powers over Option Plans

To ensure that shareholders are both aware of, and have some right to evaluate, the proposed issuance of securities of a public company to its officers and directors, we believe all national securities exchanges and national securities associations should adopt listing rules in the next 6 months that require companies to seek shareholder approval for plans that allow corporate officers or directors to acquire company securities. We intend to ask the exchanges and associations to implement such proposals, and we believe, based upon our excellent working relationships with them, that they will do so, but we would like to make this a matter of law, rather than a matter of choice.

1.5.4. More Timely Access to Reports

To ensure the greatest degree of investor access to corporate disclosure, we seek clear authority to require public companies to maintain corporate websites, and to post corporate disclosures and other documents on their websites. While we believe that we can effect this result, clearer authority would move us quickly and easily to the desired result whereby all corporations recognize that the time has come for them to understand that constant and immediate communications with shareholders are essential.

Also, to ensure the ability of the Commission to modernize the delivery of corporate information, the Commission needs unambiguous authority to permit delivery of corporate disclosure through electronic means subject to such conditions as the Commission requires for the protection of investors.

1.5.5. Private Securities Litigation

Even though more must be done to minimize the likelihood that future Enrons can occur, it is also important to recognize that there is neither enough money, nor people, to prevent hucksters from defrauding innocent investors. The SEC has a critical role to play in protecting investors. But private litigation, when properly formulated, is a very necessary supplement to the SEC's mission. To be effective, however, private litigation must be designed to help investors, not their lawyers. Though not a principal focus of concern, some have suggested that the Private Securities Litigation Reform Act of 1995 (P.L. 104–67) is somehow responsible for, or contributed to, the collapse of Enron, and that reforms, or even outright repeal of the Act, are warranted.[31] Because this Committee took the lead in promoting the PSLRA, we think it appropriate to express the Commission's position with respect to these issues surrounding the PSLRA.

The PSLRA was the subject of, literally, years of debate and consideration by the Congress. In 1995, after numerous hearings, exchanges with the Commission, and debate, the bill was initially approved by a vote of 320 to 102 (with one abstention) in the House of Representatives, and by a vote of 65 to 30 in the Senate. After President Clinton vetoed the bill, the Congress moved to override the President's veto message, voting 319 to 100 (with one abstention) in the House, and 68 to 30 in the Senate, after which the bill automatically became law.

Just prior to Congresses' consideration of the bill, then-Commission Chairman Levitt wrote to then-Senate Banking Committee Chairman D'Amato on November 15, 1995, on behalf of the Commission:

> At the outset, let us express our appreciation for your willingness to heed the concerns of the Commission . . . [W]e believe the [current] draft . . . responds to our principal concerns. We understand the need for a greater flow of useful information to investors and the markets and we share your desire to protect companies and their shareholders from the costs of frivolous litigation.[32]

Since the enactment of the PSLRA, the dollar amount of class action awards and settlements have increased substantially, while the number of issuers sued has not

[31] *See, e.g.,* "Now Who, Exactly, Got Us Into This?" *The New York Times,* Sec. 3, p. 1, dated February 3, 2002.

[32] A copy of this letter is annexed at Attachment K.

changed significantly.[33] In addition, by requiring courts to consider who the plaintiffs should be in any class action, one intended beneficial result of the PSLRA is that larger, and more thoughtful, institutional plaintiffs have become more involved in the shareholder litigation process, rejecting cases that are frivolous, but pursuing vigorously those cases that reflect serious misconduct. We should all be alert to possible unintended consequences that may arise from any legislative enactment; but, in the absence of any empirical data suggesting a nexus between the PSLRA and situations like Enron, we strongly urge the Committee to refrain from making any changes in that legislation.

2. Accounting Reforms

2.1 The Public Accountability Board

The number of sudden and dramatic reversals of public companies' financial conditions has called into question the regulatory system currently used to oversee the quality of the audits of financial statements that are filed with the Commission and relied on by investors. In particular, it appears that the current system of firm-on-firm peer reviews, overseen by a Public Oversight Board that lacks the power to direct the conduct of those reviews or to discipline auditors for unethical or incompetent conduct, has not produced a credible result. The current system does not provide investors with sufficient confidence in the efficacy of the audit process.

We are proposing "private sector" regulation, not "self" regulation. Self-regulation implies that the accounting profession would regulate itself. We are suggesting regulation by the private sector, but *not* by the profession. Rather than a body that functions under the aegis of the American Institute of Certified Public Accountants, which represents the accounting profession, the Commission announced on January 17 our intention to create a new, private sector, independent body that can direct periodic reviews of accounting firms' quality controls for their accounting and auditing practices and discipline auditors for incompetent and unethical conduct. We believe there is substantial consensus on this approach.

This private sector body would supplement our enforcement efforts, by adding a layer, or tier, of new regulation. There should be no misunderstanding. In the first instance, we, and our Division of Enforcement, will continue vigorously to investigate and pursue instances of illegal conduct. The SEC has had a successful history with two-tier regulation that involves the private sector. Such two-tier regulation has been largely successful with the brokerage industry. Private regulation presents major advantages, in terms of available resources, quality control and discipline. The SEC is best suited to bring actions for civil violations of law—fraud and such. Private regulation can govern conduct that may not be unlawful, but reflects ethical lapses or deficiencies in competence. It allows quality control that is more flexible, but also more effective. And discipline can be applied more quickly and therefore more effectively. The accounting profession and the investing public both would benefit from such an approach.

In order to understand how the Commission's proposal regarding oversight of the accounting profession is a substantial improvement over the present system, it is important to understand what has been misunderstood by many who have commented on this issue—the structure of the AICPA's Public Oversight Board. The POB was created by the AICPA in 1977 and charged with overseeing and reporting on the programs of the AICPA's SEC Practice Section (SECPS), created that same year. The SECPS is comprised of accounting firms that audit the financial statements of public companies, and establishes quality control requirements for those firms. While intended to be autonomous (the POB could set its own budget, establish its own operating procedures, and appoint its own members, chairperson, and

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[33] According to the Stanford Law School Securities Class Action Clearinghouse (available at securities.stanford.edu):

• The absolute number of issuers sued does not appear to have changed dramatically since passage of the Act, once the effects of the IPO Allocating Litigation are excluded. Litigation activity declined in 1996, but that decline was likely a transition effect.

• Since passage of the Reform Act, a larger percentage of litigation activity centers on allegations of accounting fraud, with revenue recognition issues emerging as particularly significant causes of litigation.

• Since passage of the Reform Act, a larger percentage of litigation activity also alleges trading by corporate insiders during periods when frauds are allegedly "alive" in the market.

• The dollar magnitude of settlement has increased noticeably, particularly in the settlement of "mega-cases." There have been five post-Reform Act settlements in excess of $200 million. The Cendant litigation was settled for $3.525 billion ($3.185 billion in the common equity settlement and $340 million in the Prides settlement); the Bank of America Litigation settled for $490 million; Waste Management settled two separate class actions for $457 million and $220 million; and 3Com settled a class action proceeding for $259 million.

staff), the POB relied on voluntary dues paid by SECPS members for its funding. In addition, the POB lacked the ability to organize and implement its own quality control reviews. And the POB was not given disciplinary authority. All of these deficiencies will be remedied in the private-sector regulatory regime we have proposed.

Another issue receiving a great deal of attention is whether legislation is needed to implement our proposed private sector regulatory body. First, it is critical to separate the regulatory model from the issue of whether there is a need for legislation. We think there is substantial agreement on the model we have proposed, and that is the first step in moving toward a more effective regulatory system. Legislation is not required to establish private sector regulation with SEC oversight. If the Congress determines that legislation is appropriate, however, we are committed to assist that process. Whether or not Congress acts, it is incumbent for the SEC to move forward with the most responsible proposal it can.

The new body we suggest, which we refer to as the Public Accountability Board or PAB, must have certain attributes, and its mission must be based on certain immutable principles.

2.1.1 Private Sector Regulation

Today, we are even more convinced than we were when we initially proposed the PAB in January that there must be private sector, not self regulation of the profession in the areas of discipline and quality control. The AICPA's Public Oversight Board has not been as effective as it could have been, and the disciplinary process has not been sufficiently swift or transparent. There is near total consensus on this point. Indeed, the AICPA and the major accounting firms have recognized this is a needed change to restore public confidence.

This new entity is a means to assure that accountants conform not merely to the law, but to the highest ethical and competence standards as well. In the details of our proposal that follow, such as an assured source of funding, and a required super-majority (at least) of public board members unaffiliated with the accounting profession, our guiding principle was to avoid the shortcomings of the current system, and to learn from those shortcomings. The POB was a good idea a quarter century ago, but it does not meet the needs of today.

2.1.2. Predominately Public Membership of the Board

For the same reason that we believe that public oversight, rather than self regulation, is needed to restore faith in the accounting profession, we believe that it must be clear that the PAB places the public interest and the interest of investors above all else. This means that representatives of the public must be in the position to make all significant calls on quality control and disciplinary issues. At its core, we believe the board should be composed predominantly of independent public members, unaffiliated with the accounting profession. This would help ensure oversight of the accounting profession that is free from undue influence from the accounting profession. In the Roundtables we have held so far, there has been general agreement that our proposed composition of the board—predominantly public members, not from accounting firms—was appropriate. During this Committee's recent hearings, virtually every witness endorsed the notion of a new regulatory structure of the kind we are proposing.

At the same time, we believe the public will benefit if the PAB also includes a small minority of members from the accounting profession. They bring necessary expertise and an understanding of current accounting issues. We think it ill advised to exclude them completely. As we consider reforms for oversight of the accounting profession, we need to take into account the likely effects of new initiatives—intended and unintended. If those with expertise are excluded from providing any oversight of their own profession, the PAB is likely to devolve into a board known more for its lack of understanding of issues than for its vigorous oversight. If we had to construct a board to oversee the structural integrity of a bridge, we would not exclude bridge builders or engineers. Having a small minority of members who are affiliated with the accounting profession will assure necessary expertise.

In order to obtain independence without sacrificing expertise, we believe that the PAB should be composed of public members and members associated with the accounting profession. Whether the board has a two-thirds majority of public members or three-quarters or some other super majority is an important detail, but should not detract from the underlying principle that the board must be independent, and must function independently.

To assure the quality and the independence of the members, the selection of the initial group of PAB members, and the appointment of a chairperson (who should be a public member), should be made by the Commission. After the appointment of the initial members through a selection process directed by the SEC, the PAB itself

should have the responsibility of choosing new members, and new chairpersons, to replace those who depart. Those selections should be subject to Commission approval. The PAB chairperson should always be selected from among the public members. The PAB should meet frequently, as distinguished from the current Public Oversight Board, and all of its members should be required to devote substantial time to the PAB and directly manage the entity.

The PAB appointment process should operate solely under the aegis of the SEC. The Commission has statutory authority to set accounting principles.[34] We have direct oversight responsibility for the quality of financial reporting, including enforcement powers. We recognize some witnesses and some legislative proposals would include other Government officials, such as the Secretary of the Treasury, the Chairman of the Federal Reserve Board or the Comptroller General, in the selection process on an ongoing basis. We think this involvement by additional Government officials with no direct responsibility for the governance of the accounting profession could dilute clear lines of oversight responsibility and unnecessarily complicate the selection process. In addition, we believe that the Commission, as an independent agency, should be protected from the appearance of pressure from other Government sectors and agencies.

2.1.3. Diverse, Involuntary, and Independent Funding

One of the most important steps to restore public confidence in the discipline and quality control of the accounting profession is to assure a funding source that is secure and independent. If all funding comes from the accounting profession, and voluntarily at that, as was the case with the POB, the PAB could operate under a cloud in the public's opinion. Well meaning legislative reform proposals that keep the funding source solely from the accounting profession are not as viable as those that spread the funding burden to all users of financial statements. We see funding coming from a variety of sources. First, membership in the PAB should be mandatory, in which case the PAB would be able to impose membership fees on accounting firms and their members. But, more importantly, additional funding should come from issuers whose financial statements are filed with the SEC and certified by independent public accountant members of the PAB. We believe, in contrast to a POB that is wholly dependent on voluntary funding from the accounting profession, the involuntary, broad-based funding from all users of audit services would protect the PAB from even the appearance of undue influence. We believe we have the authority under existing law to implement our funding concepts for the PAB.

2.1.4. Mandatory Membership

No matter how well conceived, the PAB will be effective only if all accountants, as well as all accounting firms, that audit public companies are required to abide by its directives. An auditor should not be able to circumvent the quality control and disciplinary mechanisms of the PAB simply by declining to register with the PAB. Therefore, we propose that membership in, and being subject to the PAB's processes, must be a prerequisite to an auditor's ability to supply audit opinions on which a registrant may rely to satisfy its filing obligations under the securities laws. Also, we propose to implement this requirement by making membership in the PAB a condition for certifying financial statements, as required under our Regulation S–X.[35]

Remaining in good standing with the PAB must also be a prerequisite to the ability to continue to audit the financial statements of public companies. As discussed in more detail below, PAB discipline, and the possibility of that discipline, must be meaningful, and to be meaningful, the failure to be in good standing with the PAB (reflected in a PAB-imposed suspension or revocation of registration, or limitation of functions) must have significant consequences.

2.1.5. Improved Quality Control Reviews

While individuals within accounting firms generally take firm-on-firm peer reviews seriously, investors and critics of the program often consider it to be a "one hand washes the other" approach to regulation.

To avoid this perception, we believe that quality control reviews should be directed and principally conducted by PAB staff, and PAB staff should make all key decisions during the conduct of the reviews. The PAB should be sufficiently staffed to carry out this responsibility, although it should be feasible for the PAB to draw

[34] *See, e.g.,* Section 19(a) of the Securities Act (15 USC 77s(a)), and Section 13(b)(1) of the Securities Exchange Act (15 USC 78m(b)(1)).

[35] Form and Content of and Requirements for Financial Statements, Securities Act of 1993, Securities Act of 1934, Public Utilities Holding Company Act of 1935, Investment Company Act of 1940, and Energy Policy and Conservation Act of 1975 (Regulation S–X), 17 C.F.R. Part 210.

upon professional personnel from the profession to assist in the reviews, as long as any such personnel are subject exclusively to PAB direction.

The PAB should promulgate standards for its quality control review process. It should publish those standards for public comment, and the standards ultimately adopted must be subject to Commission approval. The current system provides for reviews only every 3 years, which we believe is insufficient. Therefore, along with promulgating review standards, the PAB should determine how frequently to conduct routine reviews and should determine what events or circumstances will trigger nonroutine reviews. The firms that audit the vast majority of public companies should be reviewed annually.

While we believe that the Auditing Standards Board (ASB), the entity tasked with promulgating quality control standards for audits, has performed that task well, we expect that the PAB, through its work in conducting quality control reviews, will be well positioned to make very useful recommendations about those standards. We therefore believe that the PAB's mission must include the expectation that it will, as it deems appropriate, influence the agenda of the ASB and make public recommendations about quality control standards. We also believe that the ASB should have a formal mechanism for considering, and obtaining public comment on, those agenda items and recommendations.

Many commentators, and prior witnesses before this Committee, have offered suggestions on the structure of the accounting firms themselves, and how these firms could change their internal governance structure to better reflect the public interest needs. Improving risk management, improving internal controls over audit quality, enhancing the supervision of the audit process are all laudable goals. We believe many of these issues, as they reflect competency and ethical standards, could be addressed more quickly and effectively by the PAB.

Similarly, calls for a statutory imposition of an affirmative duty of supervision of audit personnel, similar to the supervisory duties that arise from the defense available under the Federal securities laws to broker dealers, may overshoot the mark.[36] The Commission already looks up the chain of command on any defective audit, when seeking to enforce the law, and we are concerned that a statutory provision may limit, rather than expand, the potential reach of the existing proscriptions.

Finally, ideas concerning the restructuring of the governance of the audit firm, requiring public members, or a majority of public members, or an independent oversight board, such as that adopted by the Andersen firm and chaired by Paul Volcker, are interesting and productive suggestions, but may be best left to individual firm consideration. The market has a large appetite for improved audit governance, and enhancements in this area should be supported by the SEC, but not mandated. We should encourage a "race to the top" in the adoption of best practices, but should be careful not to impose a one-size-fits-all solution.

2.1.6. Disciplinary Powers

The SEC has long had power to discipline accountants for failing to meet their professional standards of conduct. Rule 102(e) currently embodies that authority. The PAB should have parallel authority, such that the SEC could refer cases to it, and could take back investigations from it, at any time. This is similar to the current enforcement relationship the Commission has with NASDR and the NYSE.

Principal criticisms of the current system are that it takes too long to discipline an errant accountant, and that the sanction is not sufficient. Through mandatory membership of both firms and individual accountants in the PAB, the PAB could remove the accountant or the firm from practice before the SEC. If individual and firm membership in the PAB is a prerequisite to conducting audits of public companies, the temporary or permanent removal of an accountant or firm from the PAB's membership would operate to prevent the accountant or firm from practicing before the Commission. Additional remedies, such as limitations on the firm taking on new business, or specific quality control changes and other undertakings, should also be the subjects of PAB authority. The PAB would be required to take immediate action on any matter referred to it from the SEC. The public members of the PAB would oversee that immediate inquiry, and the public members would determine the sanctions. A further sanction would allow the PAB to require the rotation of auditors, that is, to force a public company to obtain a new firm, in light of the misconduct found on the part of the present auditor. This sanction we view as more meaningful than the wholesale call of some for automatic rotation of auditors, without any showing that there was misconduct, or a need for such rotation.

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[36] With respect to broker-dealer supervision, *see* Section 15(b)4(e) of the Securities Exchange Act of 1934.

A further concern about private sector regulation is the lack of authority to compel production of documents and testimony. Due to the required membership in the PAB for both firms and individuals, and supplemented through contractual requirements with any issuer using financial statements prepared by a PAB member, we believe the PAB could conduct rapid inquiries, with the right to revoke or suspend for a time the registration of any member firm or individual, thus providing the clout necessary to get discovery of the facts in any investigation. This could work as effectively as if the PAB had subpoena power. In fact, the SRO's regulating the brokerage community do not possess subpoena power, but through the available sanction of throwing the broker out of the business can nonetheless effectively compel cooperation in investigations. Moreover, we believe that, in cases in which the PAB was denied certain information, the Commission could assume responsibility for a particular accounting enforcement matter, and use its own subpoena enforcement authority to make sure that a full record is developed.

Persons subject to PAB disciplinary decisions should be able to obtain meaningful review of those decisions. The PAB should routinely and promptly transmit its disciplinary decisions to the Commission, and those decisions should be reviewable by the Commission either at the request of the disciplined person or on the Commission's own initiative. That review process would, of course, be public. These procedures could all be implemented under the Commission's existing statutory authority.

2.1.7. Commission Oversight

Although the Commission's relationship with the POB was based on the desire to assure the Congress and the public that the peer review process and related programs were working well, the Commission had limited ability to affect the work of the POB or the peer review program.

For the PAB to be credible, the Commission must have a direct role in the operation of the PAB's regulatory programs by exercising effective and rigorous oversight of its membership, rules, and activities. In addition, in order to promote an understanding of its processes and to inform the public of the results of its programs and proceedings, the PAB should be required to issue periodic reports.

2.1.8. Method of Formation

We believe we must act quickly to restore faith in the accounting profession and our markets that rely on it. The Commission can, through its existing authority, effectively establish a PAB with all of the attributes described above quickly. In our Roundtables regarding the proposed PAB structure, all panelists seemed to agree that integrity and competence of auditors was crucial, and that these characteristics likely cannot be legislated into existence.

We view authority for the PAB to flow from our authority to determine the nature of financial statements filed with the Commission, and the nature of the certification required on those financial statements. Just as the independence requirements of the SEC flow from its ability to define the term "independent" as used in the securities laws, so, too, do the competency and ethics requirements of Rule 102(e), and indirectly of the PAB, flow from the Commission's authority to determine the nature of the filings made to it. The Commission's authority to create an administrative disciplinary system, presently embodied in Rule 102(e) has already been judicially recognized.[37]

2.2. Auditor Independence Requirements

There has been considerable debate concerning what, if any, changes to the Commission's auditor independence rules are necessary to restore investors' confidence in the integrity of the audit process. The Commission's current rules on auditor independence were adopted less than 18 months ago, and were targeted to address problems about which there had been considerable study, discussion, and debate. The Commission's approach at that time should be tested by practical application, over a reasonable period of time. If problems are empirically shown to exist in this area, any needed reforms can be tailored to address the precise problems uncovered. Some of the restrictions on nonaudit services adopted in those auditor independence rules have not yet even taken effect, due to the rules' phase-in provisions. With this in mind, we are considering these matters carefully, in light of the rules adopted previously by the Commission, the additional evidence before us, and legislative proposals that have already been made.

Most Roundtable panelists expressed the view that critical independence issues occur in the relationship between engagement personnel and the audit client. Audit

[37] *Touche Ross & Co.* v. *SEC,* 609 F.2d 570 (2d Cir. 1979).

firms must play an important role by ensuring that audit teams adhere to the highest standards of auditing, including their independence. By focusing independence concerns on those who perform the audit, in the first instance, we can resolve the real issues confronting the profession. An individual audit partner whose income increases even by relatively modest sums of money from cross-selling consulting services may lose proper perspective in resolving difficult accounting issues. To be effective, independence restrictions must deal with both levels of concern—first, the engagement auditors should be precluded from receiving any compensation for cross-selling *any* nonaudit related services to an audit client. Second, firms must be incentivized to ensure that every audit meets the highest standards of the profession, and must be subject to meaningful sanctions where audits are not performed at those levels.

This is the analysis reflected in an AICPA policy paper I helped prepare in 1997 for submission to the then newly-created Independence Standards Board, a body formed by the SEC and AICPA to address independence issues in the profession.[38] In recent years, independence reforms have primarily focused on the independence of the firm. Narrow rules focused mainly on this area can give investors and Members of Congress the false sense that the problems that gave rise to Enron's collapse effectively have been eliminated. The Commission's responsibilities do not permit us to accept simple solutions for complicated issues. In the area of independence, we must move to a system that recognizes that true independence lies not only with the firm, but also with the engagement team, and any conflict, external or internal, that might impair the team's independence, must be addressed.

Some have suggested firewalls as a means to separate the financial and personal aspects of the consulting engagement from those who perform the audit. In its recent rulemaking the Commission did not require that auditors and their audit clients forsake all nonaudit service arrangements; those of us currently on the Commission do not believe that it is necessary to propose such a ban at this time. Information gained through consulting engagements may be useful in performing an audit. In fact, auditing literature requires auditors to ask firm personnel who have provided consulting or other services to the client if they have any information that would be relevant or useful during the audit.[39]

The Commission's existing independence requirements provide a conceptual framework to be applied to any proposed nonaudit service to determine whether that service is inconsistent with independence. We believe this framework, adopted in late 2000, will, over time, serve investors better than would a blanket ban on the receipt of nonaudit services from the auditor that certifies the financial statement. Indeed, that was the precise reason that former Chairman Levitt, in endorsing the existing rules as they had been revised, claimed that they were *better* than an absolute ban.[40]

It is useful to recall that there were large audit failures before accounting firms had any significant consulting business.[41] It should be apparent, therefore, that merely mandating the separation of consulting from auditing—to create an "audit only" firm—does not guarantee an "audit failure free" future. And there are costs to be weighed. An "audit only" firm might lack certain expertise, especially if tax consulting were eliminated, necessary to perform high quality audits. An "audit only" firm would be *more dependent,* not less, on their audit clients, and a single, large audit client could exert far more influence on such a firm than is the case with firms that have multiple sources of revenues.

We believe that limiting those services that create an inherent conflict with auditing, barring inappropriate compensation mechanisms (such as compensation for cross-selling services) and penalizing firms whose aggregate and individual audit performance is substandard (most likely by limiting the ability to take on new clients for significant periods of time and compelling termination of client relationships) are more likely to prevent audit failures than the suggestion that we increase the reliance of all audit firms on their audit clients. We believe it is appropriate to pursue, and we intend to pursue, the following changes in this area.

38 David E. Birenbaum and Harvey L. Pitt on behalf of the AICPA, SERVING THE PUBLIC INTEREST: A NEW CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE (October 20, 1997).

39 AICPA, Planning and Supervision, AU §§ 311.04*b*, 9311.03.

40 "Accounting Firms, SEC Agree on Audit Rule; Compromise Expected To Avert Legal Face-Off," *The Washington Post,* p. E01, November 15, 2000 ("Though the SEC dropped its proposed ban on information technology consulting, Levitt said, 'We got something I think is better, with the requirement for audit committee approval and disclosure.'").

41 *See, e.g., Dirks* v. *SEC,* 463 U.S. 646 (1983) (regarding trading prior to the failure of Equity Funding in 1973); *U.S.* v. *Simon,* 425 F.2d 796 (2d Cir. 1969) (regarding the financial fraud on the books of Continental Vending Machine Corporation).

2.2.1. Change of Auditors

As discussed above, allowing the PAB to exercise judgment, subject to prompt Commission review, to direct auditors to step down from an engagement could address risks that auditors that have worked with a client for a number of years may become either complacent or too dependent on the audit client.

Some have suggested the possibility of requiring that public companies replace their auditors after a specified number of years. The Commission believes that this approach, often referred to as "mandatory rotation," would be unwise. Studies over the last three decades suggest that the number of financial frauds in the first years of a new auditor's engagement is unacceptably high.[42] Mandatory periodic rotation of firms also could lead to "opinion shopping" in the decision on which new firm to select. Another concern is the unique strengths particular audit firms bring to the clients in certain industries. Large accounting firms are not fungible; one firm is not identical to another, and there can be valid market-driven reasons, such as expertise in a certain industry, for selecting and retaining one firm over others. This freedom of choice should lie with the corporation; it should not be a Government-imposed mandate or a decision delegated to the stock exchanges.

Required rotation of the lead audit engagement partner (every 7 years) could be reviewed by the PAB to determine whether a deeper rotational requirement, affecting more members of the audit team, would be advantageous. This is an area where it may be useful for the PAB, over time, to evaluate different quality control approaches to the issue and eventually make appropriate recommendations.

2.2.2. Compensation for Cross-Selling

Because the engagement partner learns a great deal about a company during the audit process, he or she might be in the best position to suggest services that a company needs and help the company find credible people to provide those services. Some firms provide additional compensation to audit engagement partners who sell nonaudit services to audit clients. The Commission believes that such compensation practices could cause serious conflicts and should be stopped.

2.2.3. Undue Influence by Clients

As discussed above, conflicts can occur if an auditor becomes overly dependent on a client, even if there is no cross-selling of services. For example, over the years the argument has been made that, since the company hires the auditor and pays the auditor's fee, the auditor can never be really independent from management. But the proposals that attempt to address this issue offer a cure that is worse than the disease. For example, there have been suggestions that the exchanges select the auditors of listed companies' financial statements. Significant practical difficulties would impede implementation of this suggestion. As discussed above, there may be very legitimate business reasons for management to prefer one auditor to others. It may be beyond the exchanges' current expertise to chose auditors, negotiate a reasonable fee, evaluate the auditor's performance, or determine if a complaint by the

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[42] Mandatory rotation of auditing firms, on some multi-year cycle, was discussed at the time of the Moss/Metcalf hearings in the mid-1970's and has often been suggested since that time. The 1977 Metcalf report states, "Rotation of audit firms and personnel has been widely discussed as a means of strengthening the independence of auditors. . . . The subcommittee believes rotation needs more study by the Commission before a sound conclusion can be reached." The rationale in support of firm rotation is that it would result in a periodic "fresh" look at the financial statements, would result in an auditor knowing that another firm will be reviewing the positions it has taken, and would limit anticipation of a longer relationship.

The Cohen Commission Report recommended against rotation of audit firms based, in part, on its finding that most audit mistakes occurred in the first year or two of an audit engagement. The Cohen Commission found that most mistakes occur in the first year or two of an audit engagement, that rotation would limit firms' incentives to "learn the business" of their clients, and that firms might be inclined to have their personnel focus on new work and lessen the attention given to matters during the last year or two of an audit.

Subsequent studies have reported information that tends to support the case against rotation. For example, the 1987 National Commission on Fraudulent Financial Reporting (Treadway Commission) examined 42 cases brought by the Commission against independent accountants from July 1981 to August 1986 and stated that these cases "revealed that a significant number involved companies that had recently changed their independent public accountants. . . . Additional research commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1999 examined 88 cases occurring between 1987 and 1997 where the Commission had alleged an audit failure and the name of the auditor could be determined. It found that 26 percent of the 88 companies changed auditors between the period in which the company issued its last "clean" set of financial statements and the period in which it issued the allegedly fraudulent financial statements. This study concluded that "most auditor switches occurred during the fraud period (versus before the fraud period). . . ."

company about an auditor was legitimate or was made because the auditor was taking tough positions on accounting and auditing issues.

There has also been a concern that engagement partners would subordinate their judgment to that of the client merely to retain the business. Firms uniformly have required consultation and review procedures to assure that engagement partners are not compromised. We would strengthen these protections by calling on audit committees to provide the necessary counter-weight to management to avoid inappropriate pressure of the accounting firm.

Finally, some have suggested that there should be either a ban on auditors going to work for audit clients or a "cooling off" period ranging from 1 to 5 years between the time the individual provided any services for the audit client and the time that he or she becomes an employee of that client. As a general matter, especially for smaller companies that have more limited options for hiring seasoned accounting personnel, this could work a serious hardship. The Commission rule adopted in 2000 provides that if a person takes on "an accounting role or financial reporting oversight role" at an audit client, then independence is impaired unless he or she does not influence the accounting firm's operations or financial policies, has no capital account at the firm, and has no financial arrangements with the firm other than a fully funded retirement plan that pays a fixed dollar amount (which is not dependent on the firm's revenues or earnings). Again, this is a rule that we believe should be evaluated after it has been given time to work. The first place we would look is to provide additional comfort against risks to independence is the audit committee. Certainly audit committees should closely examine and approve any decision to employ individuals that have provided audit services to the company.

2.3. Accounting Standard Setting

While the SEC has statutory authority to establish financial accounting and reporting standards for publicly-held companies, for over 60 years the Commission historically has looked to the private sector to provide the initiative in establishing and improving accounting principles.[43] The high quality of our accounting standards and our capital markets can be attributed in large part to the private sector standards setting process, as overseen by the SEC.

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. The FASB was designed to be an independent body, insulated from political pressure, to provide it with the opportunity to focus on creating neutral accounting standards that are transparent to the underlying economics. An oversight body appoints the members of FASB. This oversight body, the Financial Accounting Foundation (FAF), is composed of investors, business people, and accountants. The FASB's standards are designated as the primary level of Generally Accepted Accounting Principles (GAAP), which is the framework for accounting. The interpretative body of FASB, the Emerging Issues Task Force (EITF), meets every other month to provide interpretative guidance, or develop new guidance, on narrow, new, or emerging issues that arise under existing GAAP and when GAAP does not exist.

The secondary standard setter is the Accounting Standards Executive Committee (AcSEC), which provides guidance in the form of Statements of Position (SOP's), subject to the affirmative concurrence by FASB at every step in the process. The principal purpose of AcSEC, which is a committee of the AICPA, is to develop standards for specialized industries.

Some have opined that the public interest at stake in establishing accounting standards is too important for that function to be left to a nonpublic body not responsible to the Congress. Those who make this suggestion apparently have lost confidence in FASB's processes. However, we believe that the accounting standard setting function should remain in the private sector. When done properly, standard setting in the private sector is the best option for our capital markets as it provides a number of advantages over Federalized standard setting. Private sector standard setting has greater flexibility to complete rules more quickly than accounting standards set by the Government.

Federalization of the FASB not only would require substantial increases to the Federal budget, but also might disenfranchise those who are best qualified to address the highly complex business and accounting issues that must be resolved. The FASB is composed almost entirely of accounting experts and has a greater ability to attract and retain qualified personnel. Similarly, AcSEC and the EITF are composed of members with accounting expertise.

[43] *See* note 34, *supra,* and accompanying text.

Moreover, Government agencies may be more susceptible to political pressure than private bodies. This political pressure could result in the development of accounting standards that are not solely designed to meet the needs of those who use financial statements in economic decisions. For example, many question whether the FASB's proposal to expense stock compensation would have been better for investors. This concept was set forth in 1994, when it was the sense of the Senate that FASB's private sector nature should be respected and safeguarded and that Congress should not impair the objectivity or integrity of FASB's decisionmaking process by legislating accounting rules. We believe the concept remains sound today.

We do believe, however, that FASB's processes can and must be improved. In fact, even before Enron's collapse, we recognized that FASB needed to address concerns about timeliness, transparency, and complexity, and we asked FASB to address these concerns. The markets and investors simply cannot wait a decade or more for standards regarding such important matters as revenue recognition and consolidation of special purpose entities. Moreover, the work of the standard setters must result in standards that ensure illumination and not obfuscation in financial reporting.

From the beginning of my tenure as Chairman, I have recognized that the SEC historically had abdicated too much of its obligation to ensure that accounting standards meet the objectives of the Federal securities laws. The SEC consequently plans to take a more active role than it has in the last decade to ensure that standards are implemented and benefit our markets and investors. I believe that with strengthened Commission leadership and cooperation by FASB, FASB can be effective, and confidence in the process can be restored. Private-sector standard setting can work in our current business environment, even as financial transactions become more complex.

As discussed in more detail below, we plan to use our existing statutory authority to oversee the standard setting process to ensure that it functions in the best interest of investors, including by: (i) broadening funding sources to decrease FASB's dependence on revenues from the accounting profession; (ii) providing SEC input to the selection of projects on FASB's agenda; and (iii) ensuring that FASB's standards evolve to become general principle-based standards instead of overly complex, rule-based standards.

2.3.1. Involuntary Funding for the Private-Sector Standard Setter

Currently, the Financial Accounting Foundation (FAF) is responsible for selecting the members of FASB and its Advisory Council, funding their activities, and exercising general oversight. FAF receives contributions to fund FASB and approves FASB's budget. To enhance FASB's independence, we believe that its funding source should be more secure and should strengthen both the reality and the appearance of independence. Funding should be made involuntary. This funding change will help to ensure that FASB continues to be independent so that it can continue to be objective in its decisionmaking and to ensure the neutrality of information resulting from its standards. We also believe that the Commission must have a direct role in the selection and approval of the members of FASB.

2.3.2. FASB's Agenda

FASB at times has operated too slowly to be responsive to changes in the marketplace. For example, while FASB's Emerging Issues Task Force (EITF) has provided limited guidance on unique issues related to special purpose entities, FASB has been working on its overall consolidation project, which includes the consolidation of special purpose entities, for many years.

In addition, the FASB has not always added critical or significant projects to its agenda on a timely basis. For example, revenue recognition is usually the largest single item in financial statements; studies indicate that it is the single largest category of financial statement restatements, and our recent experience with actions brought by our Division of Enforcement involving financial statements indicate this is the core issue in over 50 percent of our actions. While certain narrow industry specific guidance exists, it was only on January 28, 2002, 27 years after its inception, that FASB issued for public comment a proposal to broadly address revenue recognition. Because there is no general standard on revenue recognition, issues involving revenue recognition are among the most important and the most difficult that accountants face. A final revenue recognition accounting standard could take several years to complete without a fundamental change to the FASB's current processes.

The SEC plans to work with FASB to develop a mechanism that will ensure that each project on its agenda is completed on a timely basis. Moreover, FASB must ensure that its agenda is responsive to those issues facing investors and accountants.

To help achieve that goal, the SEC will provide more input to the selection of projects to FASB's agenda, and direct FASB to address promptly priority items.

In addition, we will actively oversee the standard setting process to ensure that it functions in the best interest of investors. The SEC has exercised, and should exercise, its authority over the accounting standards it will accept for filings made with the agency. We should not use this power indiscriminately; it should be reserved for those exceptional situations where the public interest demands it. The reason for this approach by the SEC is clear: FASB has acted in the public interest and has brought a level of sophistication and professionalism to the accounting standard setting process that we should not heedlessly shunt aside.

2.3.3. Principle-Based Standards

Much of FASB's recent guidance has become rule-driven and complex. The areas of derivatives and securitizations are examples. This emphasis on detailed rules instead of broad principles has contributed to delays in issuing timely guidance. Additionally, because the standards are developed based on rules, and not on broad principles, they are insufficiently flexible to accommodate future developments in the marketplace. This has resulted in accounting for unanticipated transactions that is less transparent and less consistent with the basic underlying principles that should apply.[44] The development of rule-based accounting standards has resulted in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than to achieve economic objectives.

The SEC believes that FASB's standards, at least going forward, should evolve to become general and principle-based, instead of encyclopedic and rule-based, standards. While principle-based standards can also be subject to abuse, and some level of standardization is necessary for comparability and verifiability, we believe that principle-based standards in general are better suited to the rapidly changing financial landscape in which many companies operate. Moreover, the abuses should be minimized if our other suggestions are adopted, especially those regarding emphasis on overall accuracy and completeness of financial reporting and other disclosures, rather than disclosure based merely on compliance with specific rules. Of course, FASB and the SEC should continue to provide appropriate specification where the circumstances require and should use professional groups, like the EITF, to fill in the interstices of broad principles-based pronouncements.

SEC FUNDING NEEDS

Let me conclude with a point that may be last but is certainly not least. We need legislative assistance in increasing our funding for both this and subsequent fiscal years. The SEC regulates industries and markets that have grown enormously, in both size and complexity. The Commission currently oversees an estimated 8,000 brokerage firms employing nearly 700,000 brokers; 7,500 investment advisers with approximately $20 trillion in assets under management; 34,000 investment company portfolios; and over 17,000 reporting companies.

The President's budget for fiscal 2003 requested an appropriation of $466.9 million for the Commission, an appropriation that I supported when it was first formulated. But since the time that appropriation was formulated, pay parity legislation has passed, and the Commission has had to respond to three crises. As a result of those recent events, we critically need additional funds to enable us to phase-in a modest pay parity plan. We also need authorization to add new staff to address pressing immediate needs. We have discussed our interim personnel and resource needs with OMB, and they have indicated their receptivity to our request for an additional $15 million to fund 100 new lawyers and accountants.

1. Pay Parity

The Commission has been subject to extremely high attrition, principally because our employees earn substantially less than their counterparts in the other financial service regulatory agencies. The "Investor and Capital Markets Fee Relief Act" (P.L. 107–123), enacted this January, authorized pay parity, but the Administration's proposed fiscal 2003 SEC budget provides no new money to implement this vitally important program. Once pay parity was a reality, however, the failure to provide funding was a disappointment to our most valued employees. We estimate that an *additional* $76 million is needed to provide a modest implementation of pay parity

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[44] On February 13, 2002, the SEC Chief Accountant wrote to the Auditing Standards Board calling for them to prohibit SAS 50 letters on "hypothetical transactions," thereby preventing the potential for these preference letters to help investment bankers market structures designed to get around particular FASB principles. A copy of this letter is annexed as Attachment L.

for the agency in fiscal 2003.[45] At this critical time for the Nation's financial markets, we must rely on our most experienced, talented, valuable and productive employees. The only way to do that is for us to be able to provide our staff with pay parity at levels comparable to those with whom they regularly work at the other Federal financial regulatory agencies. If we receive funding for pay parity, I assure you that the SEC intends to make responsible increases in staff salaries and benefits, with a significant component of the increases subject to true merit pay.

The failure to fund pay parity now would only exacerbate the problems that the legislation passed by Congress last December was intended to cure. By raising expectations and hopes in anticipation of finally achieving pay parity, we will face even greater employee losses and suffer greater irreparable harm to morale if pay parity is not funded in fiscal 2003, and thereafter. Even if we can cobble together a pay parity program for the remainder of this fiscal year, which OMB has said it supports, the threat of either terminating the program in fiscal 2003 or terminating approximately 700 employees—the number we estimate would have to be cut from the agency to continue the program—would cripple many of the projects we have underway, which are important for the protection of investors and Americans whose retirement accounts are invested in the securities of public companies.

As I mentioned before, we are extremely grateful to have bipartisan backing from this Committee. We especially appreciate Chairman Sarbanes' and Senator Gramm's calls for full funding of pay parity. The SEC cannot afford to continue suffering the staffing crisis it has endured for the past decade at such an important juncture. Pay parity provides benefits we truly need to meet the increasing regulatory challenges we face. We continue to work closely with OMB to persuade them of the need for these funds. In the interim, I am committed to proceeding with our implementation of the reforms the President has directed us to effect.

2. Additional Personnel

In addition to the absence of any funds to implement pay parity, we were also given a "no-growth" budget, which means that we cannot add any new personnel. Indeed, under current funding levels for 2002, we are effectively precluded from hiring any new personnel. The solution to every problem does not start and end with larger and more expensive Government. I have started a thorough review of our deployment of personnel, to see whether we can effectuate some meaningful efficiencies.

But the tragedy of 9/11 and the very issues we are discussing here today made any contemplative review of our needs impossible. Given the enormous surge in our enforcement activities, the desire to do a better job than has been done previously at reviewing public company filings, and overseeing a restructured accounting profession, the SEC must seek a staffing increase of 100 positions in fiscal 2003 even before looking for efficiencies. This would allow us to add:

- Thirty-five accountants and lawyers in the Division of Enforcement to deal with the increasing workload from financial fraud and reporting cases.
- Thirty professional staff, including accountants and lawyers, in the Division of Corporation Finance to expand, to improve, and to expedite our review of periodic filings.
- Thirty-five accountants, lawyers, and other professionals in the other divisions—including the Office of Chief Accountant—to deal with new programmatic needs and policy.

These are the minimum staffing levels required to deal with our *immediate* post-Enron needs. Under a pay parity system, this increased staffing level will require an additional $15 million. The Commission has not received a staffing increase in the last 2 years, despite the additional responsibilities we have received as a result of the Commodity Futures Modernization Act and the Gramm–Leach–Bliley Act: Financial Services Modernization. A staffing increase is even more critical in light of recent events.

3. Additional Resources

In addition to the initiatives discussed in my testimony above, which will take substantial resources, there are other important initiatives we are undertaking in

[45] In fiscal 2001, the Commission received approval and funding to implement "special pay" to help begin addressing our recruitment and attrition problems. In fiscal 2002, we also received funding to continue special pay. The appropriation proposal for fiscal 2003 provides $19 million to fund special pay. We estimate that an additional $76 million is needed to fund pay parity for fiscal 2003.

the areas of enforcement, investor education, and technology that will require additional resources in the coming years.

- One of our major new initiatives—"real-time" enforcement—is an important component of our fiscal 2003 budget. Our goal is to provide quicker, and more effective, protection for investors, and better oversight of the markets with our limited enforcement resources. As recent experience has reinforced, the SEC must resolve cases and investigations *before* investors' funds vanish forever; that means we must act more quickly, both in identifying violations and taking prompt corrective action to protect investors. These efforts necessarily require resources, the most important of which is appropriate staffing.
- Even with our shift toward real-time enforcement and our current efforts to improve financial disclosure, the first line of defense against fraud is always an educated investor. The Commission works with numerous public and private organizations to foster investor educational programs. Our staff gives presentations to countless schools, religious organizations, and investor clubs, explaining basic investing concepts and answering questions. We also host "Investor Town Meetings" across the United States that bring together industry, Federal, and local government officials to educate investors on basic financial concepts. And this spring we will host our first "Investor Summit," to discuss policies and proposals that impact them. We want to give all Americans an opportunity and an avenue to weigh in on the broad policy objectives that ultimately could impact their ability to send their children to college or retire comfortably. We plan to use the Internet to broadcast the summit so that anyone can participate. We also are asking people to write us and call us so that we can hear the broadest possible range of viewpoints. We want to hear the concerns and aspirations of America's investors.
- Like the rest of the Government, our needs in the area of information technology continue to increase. Given the critical and increasing role of technology in the financial markets, the President's budget requests $4.0 million to fund the SEC's e-government initiatives. This is an area where the Commission needs to improve, both internally and externally. Technology is constantly altering the landscape of our markets, and SEC staff must have the necessary tools at their disposal to successfully meet the increasing demands that we face. In particular, funds proposed for fiscal 2003 will allow the SEC to get better and more timely enforcement information from the markets, enhance our intrusion detection capabilities, and meet the President's security requirements for information technology. These initiatives are a small, but important, first step toward meeting the Commission's technology needs.
- With the advent of alternative trading systems that have grown from only a handful to over 60 today, and as a result of the Internet, the SEC also must consider what effect our regulatory actions and decisions have on the industry's use of technology. To respond to this need, I have created a new position of Chief Technology Officer to provide the Commission with the technical expertise and advice necessary to improve the Commission's oversight of the markets. Generally, this office will be responsible for ensuring that the SEC's regulatory, disclosure, examination, and law enforcement programs are implemented with the benefit of a state of the art understanding of technology. Through this process, the agency can be confident that what we implement or approve is technologically sound and cost effective to the private sector.

CONCLUSION

While it remains strong, our system has shown signs of strain over the last 5 to 10 years, resulting in unacceptable and potentially avoidable losses to those who believed in the truth of what they were told and took comfort that what they did not know would not hurt them. The present financial reporting and disclosure system for public companies has not changed significantly in many decades. Investors should continue to have confidence in our present system, but there must be determination to make improvements.

I take quite seriously my stewardship responsibilities and the Oath of Office I took when I became Chairman of the Commission. I look forward to continuing to work with you to make sure that we discharge our obligations prudently, generously and in the spirit with which the Federal securities laws were adopted: To protect investors and maintain the integrity of the securities markets.

Thank you for the opportunity to testify today. I am pleased to respond to any questions the Committee may have.

How to Prevent Future Enrons
By Harvey L. **Pitt**

ATTACHMENT A

12/11/2001
The Wall Street Journal
A18

The Securities and Exchange Commission is investigating Enron's meltdown and its tragic consequences. Until all the facts are known, there is nothing that can or should be said about who may be responsible for this terrible failure. The public can be confident, however, that we will deal with any wrongdoing and wrongdoers swiftly and completely, to ensure full protection of investor interests.

Even before the Enron situation, we were working to improve and modernize our disclosure system -- to make disclosures more meaningful, and intelligible, to average investors. Our immediate concern in the wake of this tragedy should be to understand how to prevent more events like this. Of course, those with intent and creativity can override any system of checks or restraints. Believing that we can create a foolproof system is both illusory and dangerous. But investors are entitled to the best regulatory system possible, and we can achieve more than we presently do if we focus attention on finding solutions instead of scapegoats.

Our current reporting and financial disclosure system has needed improvement and modernization for quite some time. Disclosures to investors are now required only quarterly or annually, and even then are issued long after the quarter or year has ended. This creates the potential for a financial "perfect storm." Information investors receive can be stale on arrival and mandated financial statements are often arcane and impenetrable.

To reassure investors and restore their confidence, the public and private sectors must partner to produce a sensible and workable approach that includes, in addition to our existing after-the-fact enforcement actions:

-- A system of "current" disclosure. Investors need current information, not just periodic disclosures, along with clear requirements for public companies to make affirmative disclosures of, and to provide updates to, unquestionably material information in real time.

-- Public company disclosure of significant current "trend" and "evaluative" data. Providing current trend and evaluative data, as well as historical information, would enable investors to assess a company's financial posture as it evolves and changes. It would also preclude "wooden" approaches to disclosure, and encourage evaluative disclosures that begin where line-item and Generally Accepted Accounting Principles disclosures end. This information, upon which corporate executives and bankers already base critical decisions, can be presented without confusing or misleading investors, prejudicing legitimate corporate interests, or exposing companies to unfair assertions of liability.

-- Financial statements that are clear and informative. Investors and employees concerned with preserving and increasing their retirement funds deserve comprehensive financial reports they can easily interpret and understand.

-- Conscientious identification and assessment by public companies and their auditors of critical accounting principles. Public companies and their advisers should identify the three, four or five most critical accounting principles upon which a company's financial status depends, and which involve the most complex, subjective or ambiguous decisions or assessments. Investors should be told, concisely and clearly, how these principles are applied, as well as information about the range of possible effects in differing applications of these principles.

-- Private-sector standard setting that responds expeditiously, concisely and clearly to current and immediate needs. A lengthy agenda that achieves its goals too slowly, or not at all, like good intentions, paves a road to the wrong locale.

-- An environment that encourages public companies and auditors to seek our guidance in advance. The SEC must be, and must appear to be, a constructive resource and hospitable sounding board for difficult and complex accounting issues before mistakes are made. We will always need, and utilize, after-the-fact enforcement, and we can, and will, improve our review of financial reports. But by now it is painfully clear that preventing problems is

infinitely superior, and far less damaging, than acting after investor funds, retirement accounts or life savings are dissipated.

– An effective and transparent system of self-regulation for the accounting profession, subject to our rigorous, but non-duplicative, oversight. As the major accounting firm CEOs and the American Institute of Certified Public Accountants recently proposed, the profession, in concert with us, must provide assurances of comprehensive and effective self-regulation, including monitoring adherence to professional and ethical standards, and meaningfully disciplining firms or individuals falling short of those standards. Such a system has costs, but those who benefit from the system should help absorb them.

– More meaningful investor protection by audit committees. Audit committees must be proactive, not merely reactive, to ensure the quality and integrity of corporate financial reports. Especially critical is the need to improve interaction between audit committee members and senior management and outside auditors. Audit committees must understand why critical accounting principles were chosen, how they were applied, and have a basis for believing the end result fairly presents their company's actual status.

– Analyst recommendations predicated on financial data they have deciphered and interpreted. Analysts and their employers should eschew expressing views without an adequate data foundation, or when confused by company presentations.

Our system can be improved and modernized. In a crisis, some seek easy answers to difficult problems by pointing fingers. But true reform requires rigorous analysis, respect for competing views, and compromise and statesmanship by all concerned. We are up to the task, but only if we are able to tap our best minds to produce our most creative solutions, and only if we are able to discuss these issues openly and honestly. We are committed to that end, and we seek participation from everyone with an interest in our capital markets. Together, in partnership, we can make a difference. That is our vision, and our mission.

—

Mr. **Pitt** is chairman of the Securities and Exchange Commission.

ATTACHMENT B

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549 202.942.0020

NEWS RELEASE

FOR IMMEDIATE RELEASE **2001-144**

SEC Cautions Companies, Alerts Investors to Potential Dangers of "Pro Forma" Financials

Washington, DC, December 4, 2001 -- Today we are issuing cautionary advice that companies and their advisors should consider when releasing "pro forma" financial information. We believe it is appropriate to sound a warning about the presentation of company earnings and operating results on the basis of methodologies other than Generally Accepted Accounting Principles (GAAP).

We are also issuing an "Investor Alert" that describes how "pro forma" financials should be analyzed, including a reminder that they should be viewed with appropriate and healthy skepticism. Because "pro forma" financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies.

We believe that -- with appropriate disclosure -- accurate interpretations of and summaries of GAAP financial statements benefit investors. The cautionary advice and investor alert are part of our commitment to improve the quality, timeliness, and accessibility of publicly available financial information.

The Investor Alert on "pro forma" financials and the Commission's release on cautionary advice on the use "pro forma" financial information can be accessed on the SEC's Website at www.sec.gov and then clicking on "SEC Issues Caution, Alert on Pro Forma Financials."

# # #

"Pro Forma" Financial Information: Tips for investors

Investors should always take the critical step of reading the financial statements of the companies they've invested in, or intend to invest in, because financial statements contain important corporate financial information that may not be readily apparent from news releases. Recently, some companies have put out press releases using so-called "pro forma" financial information to highlight what they claim are important portions of their actual financial reports.

Investors should know that "pro forma" financial information is not prepared in accordance with the standards applied to financial statements filed with the SEC. In other words, some of the numbers announced by companies in their "pro forma" financial information may be based on assumptions or principles that are not recognized as appropriate for SEC filings, and that an accompanying news release doesn't discuss or otherwise explain. While they aren't illegal — and in some cases can be helpful in focusing attention on critical portions of financial statements —"pro forma" financials have limitations, might create a confusing or misleading impression, and should be viewed with appropriate and healthy skepticism.

The federal securities laws require most publicly held companies to file with the SEC financial statements prepared under a set of accounting conventions called "Generally Accepted Accounting Principles," or "GAAP," that are accurate, truthful and complete. When a company prepares its financial statements using GAAP, investors can more consistently track the company's financial results from year to year and compare its performance with other companies.

In contrast, "pro forma" financial results aren't prepared using GAAP, and they may not convey a true and accurate picture of a company's financial well-being. They often highlight only positive information. And because "pro forma" information doesn't have to follow established accounting rules, it can be very difficult to compare a company's "pro forma" financial information to prior periods or to other companies.

Here are a few things to keep in mind when you see "pro forma" financial information.

- **What is the company assuming?** "Pro forma" financial results can be misleading, particularly if they change a loss to a profit or hide a significant fact. For example, they may assume that a proposed transaction that benefits the company has actually occurred. Or they may fail to account for costs or charges. Be sure to look behind the numbers, and find out what assumptions the numbers are based on.

- **What is the company *not* saying?** Be particularly wary when you see "pro forma" financial results that only address one component of a company's financial results - for example, earnings before interest, taxes, depreciation,

and amortization (which is often abbreviated "EBITDA"). These kinds of statements can be misleading unless the company clearly describes what transactions are omitted and how the numbers might compare to other periods.

- **How do the "pro forma" results compare with GAAP-based financials?** Because "pro forma" information comes from selective editing of financial information compiled in accordance with GAAP, "pro forma" financial results can raise a serious risk of misleading investors - even if they do not change a loss to a profit. Look for a clear, comprehensible explanation of how "pro forma" results differ from financial statements prepared under GAAP rules, and make sure you understand any differences before investing on the basis of "pro forma" results.

- **Are you reading "pro forma" results or a summary of GAAP-based financials?** Remember that there is a big difference between "pro forma" financial information and a summary of a financial statement that has been prepared in accordance with GAAP. When financial statements have been prepared in compliance with regular accounting rules, a summary of that information can be quite useful, giving you the overall picture of a company's financial position without the mass of details contained in the full financial statements. It is always best, however, to compare any summary financial presentation you read with the full GAAP-based financial statements.

Read before you invest; understand before you commit. Remember that "pro forma" financial information you see in a press release wasn't prepared according to normal accounting conventions, and make sure you have the full story before investing. You can access and download for free a company's financial statements from the SEC's "EDGAR" database of corporate filings at www.sec.gov/edgar.shtml. There you'll find annual reports on Form 10-K, quarterly reports on Form 10-Q, and many other filings.

If you've got questions, you can contact the SEC's Office of Investor Education and Assistance for help. You can send us your complaint using our online complaint form at www.sec.gov/complaint.shtml. Or you can reach us as follows:

U.S. Securities & Exchange Commission
Office of Investor Education and Assistance
450 5th Street, NW
Washington, D.C. 20549-0213
Fax: (202) 942-9634

SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8039, 34-45124, FR-59]

AGENCY: Securities and Exchange Commission

ACTION: Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases

SUMMARY: The Securities and Exchange Commission is issuing a statement regarding the use by public companies of "pro forma" financial information in earnings releases.

FOR FURTHER INFORMATION CONTACT: John M. Morrissey, Deputy Chief Accountant, at 202-942-4400, or Paula Dubberly, Chief Counsel of the Division of Corporation Finance, at 202-942-2900.

SUPPLEMENTARY INFORMATION:

As we approach year end, we believe it is appropriate to sound a warning to public companies and other registrants who present to the public their earnings and results of operations on the basis of methodologies other than Generally Accepted Accounting Principles ("GAAP"). This presentation in an earnings release is often referred to as "pro forma" financial information. In this context, that term has no defined meaning and no uniform characteristics. We wish to caution public companies on their use of this "pro forma" financial information and to alert investors to the potential dangers of such information.

"Pro forma" financial information can serve useful purposes. Public companies may quite appropriately wish to focus investors' attention on critical components of quarterly or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations.

To a large extent, this has been the intended function of disclosures in a company's Management's Discussion and Analysis section of its reports. There is no prohibition preventing public companies from publishing interpretations of their results, or publishing summaries of GAAP financial statements.

Moreover, as part of our commitment to improve the quality, timeliness, and accessibility of publicly available financial information, we believe that – with appropriate disclosures about their limitations – accurate interpretations of results and summaries of GAAP financial statements taken as a whole can be quite useful to investors.

Nonetheless, we are concerned that "pro forma" financial information, under certain circumstances, can mislead investors if it obscures GAAP results. Because this "pro forma" financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies.

For these reasons, we believe it is appropriate to alert public companies and their advisors of the following propositions:

First, the antifraud provisions of the federal securities laws apply to a company issuing "pro forma" financial information. Because "pro forma" information is information derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information.

Second, a presentation of financial results that is addressed to a limited feature of a company's overall financial results (for example, earnings before interest, taxes,

depreciation, and amortization), or that sets forth calculations of financial results on a basis other than GAAP, raises particular concerns. Such a statement misleads investors when the company does not clearly disclose the basis of its presentation. Investors cannot understand, much less compare, this "pro forma" financial information without any indication of the principles that underlie its presentation. To inform investors fully, companies need to describe accurately the controlling principles. For example, when a company purports to announce earnings before "unusual or nonrecurring transactions," it should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.

Third, companies must pay attention to the materiality of the information that is omitted from a "pro forma" presentation. Statements about a company's financial results that are literally true nonetheless may be misleading if they omit material information. For example, investors are likely to be deceived if a company uses a "pro forma" presentation to recast a loss as if it were a profit, or to obscure a material result of GAAP financial statements, without clear and comprehensible explanations of the nature and size of the omissions.

Fourth, we commend the earnings press release guidelines jointly developed by the Financial Executives International and the National Investors Relations Institute and we encourage public companies to consider and follow those recommendations before determining whether to issue "pro forma" results, and before deciding how to structure a proposed "pro forma" statement. A presentation of financial results that is addressed to a limited feature of financial results or that sets forth calculations of financial results on a

basis other than GAAP generally will not be deemed to be misleading merely due to its deviation from GAAP if the company in the same public statement discloses in plain English how it has deviated from GAAP and the amounts of each of those deviations.

Fifth, as always, and especially in light of the disclosure that we expect to see accompanying these presentations, we encourage investors to compare any summary or "pro forma" financial presentation with the results reported on GAAP-based financials by the same company. Read before you invest; understand before you commit.

Companies with questions about the use of "pro forma" financial presentations in earnings releases are encouraged to call John M. Morrissey, Deputy Chief Accountant, at 202-942-4400, or Paula Dubberly, Chief Counsel of the Division of Corporation Finance, at 202-942-2900. Investors are encouraged to read our investor alert on "pro forma" financial statements (available at http://www.sec.gov/investor.shtml).

By the Commission.

Jonathan G. Katz

Secretary

Dated: December 4, 2001

ATTACHMENT C

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549 202.942.0020

NEWS RELEASE

FOR IMMEDIATE RELEASE **2001-147**

SEC ISSUES FINANCIAL DISCLOSURE CAUTIONARY ADVICE

Washington, D.C., December 12, 2001 — Today we are issuing cautionary advice to remind company management, auditors, audit committees, and their advisors that investors increasingly deserve and demand full transparency of accounting policies and their effects in the annual reports that public companies are required to file with us. Accordingly, the selection and application of a company's accounting policies used when preparing these reports must be appropriately reasoned.

We intend to consider new rules during the coming year to elicit more precise disclosures about the accounting policies that company management believes are most "critical" — important to the portrayal of a company's condition and results, and requiring management's most difficult, subjective or complex judgments.

The Commission's cautionary advice can be accessed on the SEC website at www.sec.gov/pdf/33-8040.pdf.

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SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8040; 34-45149; FR-60]

AGENCY: Securities and Exchange Commission

ACTION: Cautionary Advice Regarding Disclosure About Critical Accounting Policies

SUMMARY: The Securities and Exchange Commission is issuing a statement regarding the selection and disclosure by public companies of critical accounting policies and practices.

FOR FURTHER INFORMATION CONTACT: Robert A. Bayless, Special Assistant to the Chief Accountant, 202-942-4400.

SUPPLEMENTARY INFORMATION:

As public companies undertake to prepare and file required annual reports with us, we wish to remind management, auditors, audit committees, and their advisors that the selection and application of the company's accounting policies must be appropriately reasoned. They should be aware also that investors increasingly demand full transparency of accounting policies and their effects.

Reported financial position and results often imply a degree of precision, continuity and certainty that can be belied by rapid changes in the financial and operating environment that produced those measures. As a result, even a technically accurate application of generally accepted accounting principles ("GAAP") may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate an investor's understanding of the company's financial status, and the possibility, likelihood and implication of changes in the financial and operating status.

Of course, public companies should be mindful of existing disclosure requirements in GAAP and our rules. Accounting standards require information in financial statements about the

accounting principles and methods used and the risks and uncertainties inherent in significant estimates.[1] Our rules governing Management's Discussion and Analysis ("MD&A") currently require disclosure about trends, events or uncertainties known to management that would have a material impact on reported financial information.[2]

We have observed that disclosure responsive to these requirements could be enhanced. For example, environmental and operational trends, events and uncertainties typically are identified in MD&A, but the implications of those uncertainties for the methods, assumptions and estimates used for recurring and pervasive accounting measurements are not always addressed. Communication between investors and public companies could be improved if management explained in MD&A the interplay of specific uncertainties with accounting measurements in the financial statements. We intend to consider new rules during the coming year to elicit more precise disclosures about the accounting policies that management believes are most "critical" – that is, they are both most important to the portrayal of the company's financial condition and results, and they require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Even before new rules are considered, however, we believe it is appropriate to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. We encourage public

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1 See, e.g., Accounting Principles Board Opinion No. 22, "Disclosure of Accounting Policies" (Apr. 1972); AICPA Statement of Position No. 94-6, "Disclosure of Certain Significant Risks and Uncertainties" (Dec. 1994).

2 The underlying purpose of MD&A is to provide investors with "information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." Item 303(a) of Regulation S-K [17 CFR 229.303(a)]. As we have previously stated, " '[i]t is the responsibility of management [in MD&A] to identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the company.' " Securities Act Rel. No.

companies to include in their MD&A this year full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure is consistent with the objective of MD&A.

Investors may lose confidence in a company's management and financial statements if sudden changes in its financial condition and results occur, but were not preceded by disclosures about the susceptibility of reported amounts to change, including rapid change. To minimize such a loss of confidence, we are alerting public companies to the importance of employing a disclosure regimen along the following lines:

1. Each company's management and auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements. As part of the normal audit process, auditors must obtain an understanding of management's judgments in selecting and applying accounting principles and methods. Special attention to the most critical accounting policies will enhance the effectiveness of this process. Management should be able to defend the quality and reasonableness of the most critical policies, and auditors should satisfy themselves thoroughly regarding their selection, application and disclosure.

2. Management should ensure that disclosure in MD&A is balanced and fully responsive. To enhance investor understanding of the financial statements, companies are encouraged to explain in MD&A the effects of the critical accounting policies applied, the judgments made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail.

6835 (May 18, 1989) [54 FR 22427] (quoting Securities Act Rel. No. 6349 (Sept. 28, 1981) [not published in the Federal Register]).

3. Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods.[3] Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.

4. If companies, management, audit committees or auditors are uncertain about the application of specific GAAP principles, they should consult with our accounting staff. We encourage all those whose responsibility it is to report fairly and accurately on a company's financial condition and results to seek out our staff's assistance. We are committed to providing that assistance in a timely fashion; our goal is to address problems before they happen.

By the Commission.

Jonathan G. Katz
Secretary

Dated: December 12, 2001

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[3] See Codification of Statements on Auditing Standards, AU § 380, Communication with Audit Committees or Others with Equivalent Authority and Responsibility ("SAS 61"). SAS 61 requires independent auditors to communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, specifically the audit committee. Among the matters to be communicated to the audit committee are: (1) methods used to account for significant unusual transactions; (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; (3) the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates; and (4) disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements. Id.

ATTACHMENT D

SEC NEWS DIGEST

Issue 2001-245 December 21, 2001

COMMISSION ANNOUNCEMENTS

STATEMENT OF SEC CHAIRMAN HARVEY L. PITT

On December 20, the Securities and Exchange Commission Chairman Harvey L. Pitt issued the following statement:

On behalf of the entire Securities and Exchange Commission, I want to express our deep appreciation to the Congress for its passage earlier today of landmark legislation that reduces excess and unfair fee collections on securities transactions, and offers pay parity to the hardworking, and deserving, staff of the SEC. Those of us who serve at the Commission are privileged to regulate our nation's capital markets, and enforce our federal securities laws. Our staff works tirelessly and enthusiastically to promote and protect our markets and to ensure the confidence of all investors that US capital markets are the fairest and best markets worldwide.

With the passage of this legislation, and assuming its enactment into law as well as its full funding, we believe we will be able to continue to attract and retain outstanding staff. All of us gladly acknowledge that government is a service business, and we are each pledged to having the Commission represent a model of governmental efficiency and effectiveness. Pay parity goes a long way toward making our pledge the public's reality. (Press Rel. 2001-150)

PROGRAM TO MONITOR ANNUAL REPORTS OF FORTUNE 500 COMPANIES

Our Corporation Finance Division has determined to monitor the annual reports filed by all Fortune 500 companies that file periodic reports with the Commission in 2002 as part of its process of reviewing financial and non-financial disclosures made by public companies. Through this process, the Division will focus on disclosure that appears to be critical to an understanding of each company's financial position and results, but which, at least on its face, seems to conflict significantly with generally accepted accounting principles or Commission rules, or to be materially deficient in explanation or clarity. Where problems are identified, the Division will select the filing for expedited review. As always, all companies are encouraged to consult with our staff if there are questions concerning disclosure issues before they file their reports. We and our staff are committed to providing that assistance in a timely fashion; our goal is to address problems before they happen.

ATTACHMENT E

Public Statement by SEC Chairman: Regulation of the Accounting Profession

by

Chairman Harvey L. Pitt

U.S. Securities & Exchange Commission

SEC Headquarters, Washington, D.C.

January 17, 2002

Over the last decade or so, this Country's vaunted system of disclosure, financial reporting, corporate governance and accounting practices has shown serious signs of failing to keep up with the needs of today's investors, our economy, and new technology that makes rapid communications not only possible but essential. The latest example - a most tragic and unprecedented one - is the failure of Enron.

There are two distinct facets to the "Enron situation." The first is finding out who did, or who failed to do, what, and who bears responsibility for the horrendous losses imposed on Enron's investors and employees. As I have said before, the Commission is actively and aggressively investigating these circumstances. Our investigation will be thorough, and will deal effectively with any wrongdoing that may have occurred. The second facet of Enron is to see what lessons we can begin to learn about how to prevent failures like this from recurring.

Our disclosure and financial reporting system is still the best in the world, but it has long needed improvement. Its inadequacies are more visible after Enron's failure, and the need for change cannot be ignored any longer. This is not a problem that arose overnight. Investors here and abroad are entitled to rely upon our system as the finest in the world. We intend to fulfill that responsibility.

There are many aspects of this problem. Our system of periodic disclosure, for example, is old and not good enough. Today, disclosures are made not to inform, but to avoid liability. We need to move to a system of "current" disclosure. The present system, which has been in effect for 67 years, doesn't provide for "current disclosure."Financial disclosures are dense, impenetrable. We have called for plain English financial statements. Corporate governance issues and the role of Audit Committees are also in need of review. We recently alerted companies and their Audit Committees of the need for transparent disclosure of key accounting principles and policies in annual reports. Very shortly, we intend to issue a statement on MD&A disclosure that seeks to promote greater consideration of the intent of MD&A, which is to give investors a view of the company through the

eyes of management, on critical financial issues.

We need more prompt action by the FASB, the nation's accounting standard setter. And, we at the SEC need to improve the way we oversee our disclosure and financial reporting system.

Finally, there is a need for reform of the regulation of our accounting profession. We cannot afford a system, like the present one, that facilitates failure rather than success. Accounting firms have important public responsibilities. We have had far too many financial and accounting failures. The Commission cannot, and in any event will not, tolerate this pattern of growing restatements, audit failures, corporate failures and investor losses. Somehow, we must put a stop to a vicious cycle that has been in evidence for far too many years.

In addressing this myriad of issues, we will be creative and expeditious in exploring and pursuing private, regulatory and legislative avenues of action.

To return to the accounting and auditing system, while there are many facets of our system that need repair, the potential loss of confidence in our accounting firms and the audit process is a burden our capital markets cannot and should not bear. Given that we are now in the process of year-end audits, and given the enormous – and appropriate – attention being focused on the role of accountants in some of these corporate failures over the last decade, we have taken the initiative to begin the process of restructuring the regulatory system that governs the accounting profession.

Toward that end, even before Enron's collapse, we called upon the accounting profession to work with us to resolve its vulnerabilities and weaknesses. The Commission, not the profession, must take a leading role in protecting the public interest; this effort requires a reordering of perspectives and priorities within the profession. The profession has shown great willingness to work with us to produce a better regulatory system.

In our vision, this system must at heart be a tough, no-nonsense, fully transparent disciplinary system, subject to independent leadership and governance. In addition, there must be regular monitoring of the ways in which accounting firms perform their responsibilities, and the areas in which either individual firms or the profession as a whole, can improve.

The system we envision must be thoroughly vetted with all major constituencies, and we have advised the relevant Congressional committees that oversee our efforts that we will work closely with them to ensure that the framework we ultimately propose meets their notion of what is appropriate in the interests of investors.

There have been public reports of some of the components included in the system we are examining. In brief, here are some of the components we believe should be a part of this process. We initially envision a new body dominated by public members, with two primary components – discipline and quality control. Let me speak to those two elements:

Discipline

1. The system should be subject to a new body that is dominated by public membership.

2. The SEC should decide whether conduct should be pursued as violations of law (in which case the SEC would handle it), or pursued as violations of ethical and/or competence standards (in which case they would be handled by the private sector regulatory body)

3. The body should be empowered to perform investigations, bring disciplinary proceedings, publicize results, restrict individuals and firms from auditing public companies

4. The disciplinary proceedings should proceed expeditiously

5. Disciplinary actions should be subject to SEC oversight

Quality Control

1. There should be a reform of the current peer review process that avoids firm-on-firm review

2. The new process should replace the current triennial firm-on-firm peer review with more frequent monitoring of audit quality and competence designed to produce better audits in the future

3. There should be a permanent Quality Control staff, composed of knowledgeable people unaffiliated with any accounting firm

4. The staff should be deployed and overseen by the new publicly dominated body and its staff

We are at the early stages of this proposal, and many details remain to be worked out. The SEC will carefully review this and other proposals regarding a system of public sector regulation to ensure that it addresses our concerns with the current system.

A strong accounting profession is key to our capital system, and we are firmly committed to assuring that it functions properly, expeditiously and in the public interest. Significant work remains to be done, but we are confident that with input from all sectors we can erect a system that will restore public confidence in the integrity of the accounting profession.

http://www.sec.gov/news/speech/spch535.htm

ATTACHMENT F

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549 202.942.0020

NEWS RELEASE

FOR IMMEDIATE RELEASE **2002-13**

SEC ISSUES STATEMENT ON DISCLOSURE REQUIREMENTS FOR PUBLIC COMPANIES

Washington, DC, January 22, 2002 – The Securities and Exchange Commission today issued a statement setting forth certain of its views regarding disclosure that should be considered by public companies while preparing annual reports for the year recently ended. The statement is posted on the Commission's web page www.sec.gov under Regulatory Actions, Other Commission Orders, Notices, and Information.

The Commission's statement reminds public companies of existing disclosure requirements and suggests steps companies, domestic and foreign, should consider in meeting those requirements, regarding:

- liquidity and capital resources, including off-balance sheet arrangements,
- certain trading activities that include non-exchange traded contracts accounted for at fair value, and
- effects of transactions with related and certain other parties.

"We need better disclosure about these matters in this reporting season," said SEC Chief Accountant Robert K. Herdman. "While existing rules mandate explanations of material uncertainties, our hope is that public companies will go beyond the minimum legal requirements and serve investors with the very best possible discussion of the company's financial position and operating results. The Commission will continue to study how it can bring about further improvements in disclosure concerning critical accounting policies, important assumptions underlying reported results and material off-balance sheet activities, among other topics."

The Commission's statement refers to recommendations contained in a petition for interpretive guidance from the five largest accounting firms, which was endorsed by the American Institute of Certified Public Accountants. That petition is posted on the Commission's web page www.sec.gov under Regulatory Actions, Petitions for Rulemaking.

The statement does not create new legal requirements, or modify existing legal requirements. The Commission also is considering whether to propose rules in the future to improve the consistency and completeness of disclosure about the particular risks, relationships and activities addressed in the petition and this statement.

For further information, contact:

Jackson Day	(202) 942-4400
Robert Bayless	(202) 942-4400
Paula Dubberly	(202) 942-2900

# # #

ATTACHMENT G

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549 202.942.0020

NEWS RELEASE

FOR IMMEDIATE RELEASE **2002-22**

SEC TO PROPOSE NEW CORPORATE DISCLOSURE RULES

Washington, DC, February 13, 2002 -- The Securities and Exchange Commission today announced that it intends to propose changes in corporate disclosure rules as the first in a series of steps designed to improve the financial reporting and disclosure system.

"The steps we announce today represent only a beginning in the realization of an important regulatory agenda," SEC Chairman Harvey Pitt said. "These steps will provide significant improvements quickly while other proposals are considered. We will be working on our own and together with Congress, the President's Working Group, companies, investor groups and other interested participants. We anticipate further reform proposals covering financial reporting and disclosure requirements, accounting standard setting, regulation of the auditing process and profession and corporate governance."

Specifically, the Commission intends to propose rules that will:

- Provide accelerated reporting by companies of transactions by company insiders in company securities, including transactions with the company;

- Accelerate filing by companies of their quarterly and annual reports;

- Expand the list of significant events requiring current disclosure on existing Form 8-K. Such events could include changes in rating agency decisions, obligations that are not currently disclosed and lock-out periods affecting employee stock-ownership plans.

- Add a requirement that public companies post their Exchange Act reports on their web sites at the same time they are filed with the SEC; and

- Require disclosure of critical accounting policies in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in annual reports.

"Our financial disclosure system is the best in the world," Pitt said. "Investors can be confident in the system as we continue to work to improve it."

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DETAILS OF PROPOSED CORPORATE DISCLOSURE RULES

Proposed Amendments for Insider Reporting

The Commission is considering a variety of ways to improve public disclosure of trading activities by executive officers, directors and beneficial owners of 10% of a company's stock.

Under the Securities Exchange Act of 1934, trades must be reported by the tenth day of the month following the month in which the trades occur. That represents a delay of up to 40 days, which is inadequate for today's markets. The Commission supports a legislative solution that would dramatically shorten this period.

In the meantime, given the importance to the marketplace of transactions by corporate executives and directors, the Commission intends to propose that, pursuant to their reporting obligations, companies disclose on a current basis significant transactions in the company's stock by their executive officers and directors.

As a complement to this initiative, the Commission is seeking ways to provide for electronic filing of reports of insider transactions. Direct reporting on the EDGAR system by insiders would entail the distribution and monitoring of literally tens of thousands of personal identification numbers to these insiders. Accordingly, the Commission is considering an approach that would require companies to file electronically information that they receive from insiders, including under new accelerated requirements such as those described above.

In addition, the Commission is re-examining an existing provision in its rules that permits officers and directors that sell stock back to their company to delay reporting until 45 days after the end of the fiscal year in which the transaction took place. This current provision allows a potential reporting delay of many months. To eliminate this delay, the Commission intends to propose that a company report on a current basis any transactions involving securities of the company entered into with any of its executive officers or directors.

Proposed Amendments for Mandated Secondary Market Reporting

The Commission's secondary market disclosure system under the Securities Exchange Act of 1934 requires U.S. public companies to make disclosure at annual and quarterly intervals, with limited, specified events reported on a more current basis. The Commission believes that the time periods for filing under this system need to be shortened and the list of events requiring more current reporting needs to be expanded.

Annual and Quarterly Reports

The Commission intends to propose that public companies file their annual reports on Form 10-K within 60 days after the end of their fiscal year, rather than 90 days. The Commission also intends to propose that public companies file their quarterly reports on Form 10-Q within 30 days after the end of their first three fiscal quarters, rather than 45 days. The time periods for filing these reports have not changed in over 30 years, despite previous attempts to do so. The significantly reduced time periods for the capture and analysis of information and significant technological advances since these time periods were last revised necessitate a new consideration of the timing of mandated disclosure to the markets.

Current Reports

The Commission believes that markets and investors need more timely access to a greater range of important information concerning public companies than what is required by the existing reporting system. Accordingly, the Commission intends to expand the types of information that companies must report on Form 8-K. Some of the items that the Commission is evaluating for inclusion in these reports include:

- Changes in rating agency decisions and other rating agency contacts;
- Transactions in the company's securities, including derivative securities, with executive officers and directors;
- Defaults and other events that could trigger acceleration of direct or contingent obligations;
- Transactions that result in material direct or contingent obligations not included in a prospectus filed by the company with the Commission;
- Offerings of equity securities not included in a prospectus filed by the company with the Commission;
- Waivers of corporate ethics and conduct rules for officers, directors and other key employees;
- Material modifications to rights of security holders;
- Departure of the company's CEO, CFO, COO or president (or persons in equivalent positions);
- Notices that reliance on a prior audit is no longer permissible, or that the auditor will not consent to use of its report in a Securities Act filing;
- Definitive agreement that is material to the company (negotiations of agreements would be excluded from this requirement unless and until a definitive agreement is entered into);
- Any loss or gain of a material customer or contract;
- Any material write-offs, restructurings or impairments;
- Any material change in accounting policy or estimate;

- Movement or de-listing of the company's securities from one quotation system or exchange to another; and
- Any material events, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans.

Given the significance of current disclosure of these events to participants in the secondary markets, the Commission intends to propose that companies file reports of these events no later than the second business day following their occurrence. The Commission also is considering whether some of these events require filing by the opening of business on the day after the occurrence of the event.

Disclosure on Company Web Sites

The Commission believes that mandated public company disclosure should be more readily available to investors in a variety of locations. To further this goal, the Commission intends to propose amendments that would require public companies to make their Exchange Act reports available on their Internet web sites, if available, at the same time as they are filed. This requirement would not in any way replace or reduce a company's obligation to file with the Commission.

Disclosures about Critical Accounting Policies

The Commission intends to propose amendments to its rules for Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) to require disclosure about critical accounting policies. As described in a Cautionary Advice Release issued by the Commission on December 12, 2001, critical accounting policies are those that are both most important to the portrayal of a company's financial condition and results, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

The proposals may require public companies to include in their MD&A full explanations, in clear and understandable format and language, of their critical accounting policies, the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure would be consistent with the objective of MD&A to provide information on events or uncertainties known to management that would have a material impact on reported financial information. Such disclosure would assist investors in understanding a company's financial condition, changes in financial condition, and results of operations.

ATTACHMENT H

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549 202.942.0020

NEWS RELEASE

FOR IMMEDIATE RELEASE **2002-23**

PITT SEEKS REVIEW OF CORPORATE GOVERNANCE, CONDUCT CODES

Washington, DC, February 13, 2002 - As part of an ongoing effort to bolster investor confidence, Chairman Harvey L. Pitt of the Securities and Exchange Commission has asked the New York Stock Exchange and Nasdaq to review corporate governance and listing standards, including the important issues of officer and director qualifications and the codes of conduct of public companies.

"Recent events have underscored the need for public companies to have a strong commitment to full disclosure and compliance with all regulatory regimes to which their companies are subject," Pitt said in a letter to the chairmen of the NYSE and Nasdaq. "While no set of rules can stop every venal actor determined to put personal interests ahead of those of the companies they manage, we believe that there are a number of ways that current corporate governance standards can be improved to strengthen the resolve of honest managers and the directors who oversee management's actions."

Pitt commended the NYSE for establishing a Special Committee on Corporate Accountability and Listing Standards to examine corporate governance issues, including the possibility of requiring continuing education programs for officers and directors. The Nasdaq is taking similar steps.

Separately, Pitt commended Financial Executives International for reemphasizing its members' code of ethics and asked FEI to consider whether there is a need to update the code in light of recent developments.

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ATTACHMENT I

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549 202.942.0020

NEWS RELEASE

FOR IMMEDIATE RELEASE **2002-39**

SEC ANNOUNCES REPORTING REQUIREMENTS FOR COMPANIES AUDITED BY ANDERSEN LLP

Washington, DC, March 18, 2002 – The Securities and Exchange Commission today released the orders and rules it announced on March 14, 2002. The Commission issued these orders and rules to assure a continuing and orderly flow of information to investors and the U.S. capital markets in light of the indictment of Arthur Andersen LLP.

"We are committed to ensuring that investors continue to receive the timely financial information to which they are entitled," said SEC Chairman Harvey L. Pitt. "The Commission believes that the actions it is taking will address any issues that might arise from Andersen's indictment. Any potential disruptions are anticipated to be minimal and of relatively short duration. If other actions are needed, the Commission will take further appropriate steps."

As announced last week, the Commission has been assured by Andersen that it will continue to audit financial statements in accordance with generally accepted auditing standards (GAAS) and applicable professional and firm auditing standards, including quality control standards. Andersen has also told the Commission that if it becomes unable to continue to provide those assurances, it will advise the Commission immediately. Issuers for which Andersen issues signed audit reports after March 14, 2002, must obtain from Andersen similar representations and generally must set forth those representations in their filings. Under those procedures, the Commission will continue to accept financial statements audited by Andersen in filings.

The orders and rules released today also establish a framework for Andersen clients that are unable to obtain from Andersen or elect not to obtain from Andersen a signed report on audits that are currently in process. As to those issuers, the Commission will require adherence to existing filing deadlines, but will accept filings that include unaudited financial statements from any issuer unable timely to provide audited financial statements. Issuers electing this alternative generally will be required to amend their filings within 60 days to include audited financial statements. This alternative framework is procedural in nature, is of finite duration, and is intended solely to address timing constraints and temporary disruptions that the affected issuers may face.

The Commission is permitting affected issuers to file annual reports, certain registration statements, and certain other filings by the original due date with *unaudited* financial statements, so long as they file, within 60 days after the original due date, amended filings containing *audited* financial statements. For affected issuers that are registrants under the Securities Act of 1933, the Securities Exchange Act of 1934, the

Public Utility Holding Company Act of 1935, the Investment Company Act of 1940, or the Investment Advisers Act of 1940, the relief that the Commission's actions provide includes the following:

- extensions of time to file audited financial statements required in annual reports and certain other reports filed with the Commission;
- extensions of time to make audited financial statements available to shareholders;
- extensions of time to obtain reviews of financial statements for quarterly reports; and
- extensions of time, for companies that are already reporting to the Commission, to include required audited financial statements in registration statements.

In addition, affected issuers will be able to satisfy filing requirements for tender offers under the Williams Act, acquisition proxy statements, employee benefit plans, financial statements of unconsolidated subsidiaries and guarantors and transactions, and to comply with the conditions of Rule 144, Rule 144A, Rule 701, or Regulation D, by filing unaudited financial statements by the original due date, so long as audited financial statements are filed within 60 days after the original due date.

The Commission continues to emphasize that companies should make their own independent decisions regarding completion of current audits and reviews and that these actions are intended only to provide neutral flexibility for companies as they make those decisions. Consistent with this approach, the Commission's actions do not apply to signed audit reports by Andersen issued on or before March 14, 2002.

The Commission has also determined that it is not necessary or appropriate to make this alternative framework available in the case of initial public offerings, initial registrations under the Exchange Act, going-private transactions or roll-up transactions. The alternative framework is also unavailable with respect to filings or transactions by any "blank check companies."

The Commission determined that it is in the public interest to make its actions effective upon publication of the Commission's orders and rules.

For more detail concerning these actions, please contact the Commission, as indicated below.

- Investors with questions can call a special hotline maintained by the Commission's Office of Investor Education at 1-800-SEC-0330 or e-mail the office at help@sec.gov.

- Issuers with questions regarding Securities Act or Exchange Act filings, please call the Division of Corporation Finance's hotline at 202-942-2816 or e-mail the Division at cfhotline@sec.gov.

- Auditors with transition questions may call the Office of the Chief Accountant at 202-942-4400 or e-mail the office at oca@sec.gov.

- For questions regarding broker-dealers, self-regulatory organizations, and transfer agents, please call the Division of Market Regulation's hotline at 202-942-0069 or e-mail the Division at marketreg@sec.gov.

- For questions regarding investment companies, investment advisers or public utility holding companies, please call the Division of Investment Management's hotline at 202-942-0590 or e-mail the Division at IMOCA@sec.gov.

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ATTACHMENT J

March 2002

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FEI Observations and Recommendations

Improving Financial Management, Financial Reporting and Corporate Governance

Overview

Presented here are the views of Financial Executives International (FEI) on reforms aimed at strengthening financial management, reporting and corporate governance. We believe that most companies are governed and managed ethically and are fulfilling their fiduciary obligations to their stakeholders. However, the investing public and FEI share a common concern over the problems highlighted by the recent failures of corporate management, financial reporting, corporate governance, audit committees and independent audits. The U.S. capital markets are based, in large part, on trust in a checks-and-balances control system fundamental to good corporate governance. The weaknesses exposed in the system are highlighted in public documents, testimony before Congress, press interviews and special reports. We believe these revelations point to certain systemic issues and call for reform. FEI supports a clear and coordinated look at all areas of possible improvement. It is our intention to assist in this effort by making the following observations and recommendations.

We believe the following factors may have contributed to the recent problems observed in the areas of corporate governance, ethical management, financial reporting and external audits:

- Lack of ethical conduct and inappropriate "tone at the top"
- Failure of effective board oversight
- Lack of financial expertise on audit committees
- External audit failure due to compromised independence and failed quality control procedures
- Overly complex accounting standards
- Opaque financial reporting
- Emphasis on form over substance in applying accounting standards

We offer recommendations in four areas:

Strengthening financial management and commitment to ethical conduct

Rebuilding confidence in financial reporting, the accounting industry and the effectiveness of the audit process

Modernizing financial reporting, and reforming the accounting standards-setting process

Improving corporate governance and the effectiveness of audit committees

Recommendations

Strengthening Financial Management and Commitment to Ethical Conduct

Recommendation 1: All financial executives should adhere to a specialized code of ethical conduct.

FEI recommends that all senior financial professionals be required to adhere to a strong ethical code of conduct. For many years, members of FEI have signed such a code, thus committing to its principles. That code has been updated recently to include a call for all financial executives to acknowledge their affirmative duty to proactively *promote* ethical conduct in their organizations.

Whether or not they are members of FEI, all finance professionals should adhere to a code of ethical conduct containing all the elements of the FEI Code of Ethics. The Code states, for example, that financial arrangements involving actual or apparent conflicts of interest should be avoided.

FEI recommends that all senior financial officers, accounting officers, controllers, treasurers and chief investor relations officers annually sign a code containing all the elements of the FEI Code of Ethics and deliver it to their board or the board's designated committee. Further, we expect that best practice in this area will be that **all** finance, accounting, tax and investor relations personnel annually sign such a code.

The FEI Code is attached to this document as Appendix A.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

Recommendation 2: Companies should actively promote ethical behavior and provide employees with the means to report perceived violations of ethical standards without fear of reprisal.

FEI strongly endorses practices by which all companies adopt a code of conduct for their employees and conduct regular training sessions to assure understanding and compliance. We believe companies should provide support and broad protection to employees reporting code of conduct violations. Under such a framework, companies should:

- Adopt a written code of conduct for all employees
- Conduct employee orientation and training with respect to the code
- Provide employees with a mechanism (such as a hotline or help-line) to surface concerns about compliance with laws and regulations
- Adopt procedures for voluntary disclosure of violations of laws
- Participate in best practices forums
- Inform the public of the active commitment to implement these steps

We encourage all companies to set up "hotline" channels, providing employees with the means to report perceived violations of the code or of the law without fear of reprisal. Additionally, employees should be made aware of these lines of communication and be assured that the source of all calls will be kept confidential. Calls should go directly to a person, facilitator or committee specifically identified by the company's board. That designated person or entity should screen each call and initiate appropriate action within the company. The company's board of directors should be informed of calls made and their disposition on a regular basis.

Recommendation 3: Qualifications of the principal financial officer and principal accounting officer.

Management, in support of the audit committee and board of directors, should designate a principal financial officer and a principal accounting officer as those terms are used in the Securities Act of 1933. FEI believes the qualifications and roles of such persons should include the following:

- The principal financial officer should be that person with overall responsibility for the finance function within the reporting company, and should have knowledge in all areas of finance including, at a minimum, the requisite knowledge proposed for the financial experts of audit committees. The principal financial officer should be responsible for upholding compliance with ethical standards within the finance function.

- The principal accounting officer should be a licensed public accountant or possess equivalent knowledge and experience, and should be current and knowledgeable in the understanding of GAAP and the SEC's rules and regulations governing the preparation and audit of financial statements.

- The principal financial officer should report to the chief executive officer, and the principal accounting officer should report to the principal financial officer. It is further recommended that the principal financial officer and/or the principal accounting officer meet with the audit committee periodically (quarterly) to review significant financial statement issues, including key judgments, estimates and disclosure matters.

Rebuilding Confidence in Financial Reporting, the Accounting Industry and Effectiveness of the Audit Process

Recommendation 4: Create a new oversight body for the accounting profession staffed with finance and accounting professionals.

Enhanced oversight of public accounting firms by an independent body would increase public confidence in the audit process and effectiveness of the audit quality control process. This oversight board should be sponsored by the SEC and, recognizing the technical nature involved and the need to adequately understand the audit process, the majority of its members should be executives with knowledge in accounting and finance. These individuals should be clearly independent of public accounting firms or other audit industry organizations. We do not believe that a majority of members should be drawn from the audit profession.

This oversight board should oversee the peer review quality control process of the audit firms. Furthermore, the peer reviewers should be accountable to the oversight board for the scope of review, findings, recommendations and corrective actions.

We further recommend that a focused mission and scope will enhance the effectiveness of this body. Therefore, this new body should be principally tasked with the job of audit industry oversight and discipline. As FEI continues to support private-sector accounting standard setting, we believe that a separate and independent body should continue to oversee the FASB.

Recommendation 5: Place restrictions on certain non-audit services supplied by the independent auditor.

Even the appearance of a potential conflict of interest may now undermine an auditor's effectiveness. Therefore, we believe confidence in the integrity of the audit would be enhanced if certain non-audit services were prohibited for audit clients. In this regard:

- The independent auditor should no longer provide audit clients with internal audit services or consulting on computer systems used for financial accounting and reporting.
- Advisory services should be prohibited wherever the audit firm could be put in a position of relying on the work product resulting from such services.
- Tax advisory and compliance services, acquisition due diligence, audits of employee benefit plans and other statutory audits should be acceptable services for audit clients as they would not normally raise questions of conflict of interest. In the unusual instance where such services could present questions of a conflict of interest, such services should not be provided.

Importantly, in addition to the foregoing, we suggest that audit committees approve substantially all large non-audit services. In so doing, the audit committee should consider the impact of such services on the overall independence of the audit firm.

FEI also recommends that the SEC redefine the current classifications of audit and non-audit services to assure that the guidance is clear and that the distinction conveys a complete and meaningful picture to investors in regard to the proper characterization of audit and non-audit activities.

Recommendation 6: Restrict the hiring of senior personnel from the external auditor.

FEI recommends that companies adopt policies that restrict the hiring of engagement audit and tax partners, or senior audit and tax managers, who have worked on the company's audit for a period specified by the board of directors. FEI believes that this period should be no shorter than two years.

Modernizing Financial Reporting and Reforming the Accounting Standards-Setting Process

Recommendation 7: Reform the Financial Accounting Standards Board (FASB).

FEI recommends that a "Blue Ribbon Committee" be formed to address FASB reform. While we support continuing private-sector standard setting through the FASB, substantive process and structural changes are long overdue. The Blue Ribbon Committee should complete its work promptly and produce initial recommendations within three months of its formation. The Committee should be guided by the basic principle of advancing financial reporting, notwithstanding divergent political interests. The Committee should address the following issues:

- FASB Organization
  - Board mission statement
  - Size of board
  - Length of board member terms
  - Voting majority
  - Staff effectiveness, accountability and structure
  - Restrictions on board member meetings ("Sunshine Rules")

- Timely Standard Setting
  - Timely standard setting with clearly defined priorities, objectives and milestones
  - Agenda management and accountability

- Financial Statement Content
  - A process for defining clear long-term objectives for financial statements produced under GAAP
  - Fair value accounting, in particular, needs to be addressed, given the absence of market values in many areas and the potential for such accounting concepts to create financial statement volatility

- Financial Accounting Standards
  - Reassess the conceptual framework as the basis for standard setting
  - Assure practical implementation of principle-based standards vs. specific, bright-line rules; examples of standard application and financial interpretations based on principles underlying standard
  - Impact of planned globalization of accounting standards
  - Review existing standards and disclosures
  - Address the need to increase the participation of the user and investment community and decrease tension with the preparer community

Recommendation 8: Modernize financial reporting.

FEI expresses strong support for the following improvements in financial reporting and recommends that committees be formed promptly to address these matters.

- Improve Management's Discussion and Analysis (MD&A)
  - FEI should take the lead in developing best practices for MD&A disclosure utilizing 2001 annual reports as a primary source for data.

- Implement "Plain English" financial reporting as the new language of professionals involved in investor relations and financial statement preparation.

- Promote voluntary disclosures of business performance metrics
  - FEI recommends that companies consider providing Web-based reporting of key performance measures used by management and specific to the industry on a quarterly basis. (A possible source for additional key performance measures is information shared at analyst presentations.)
  - In order to encourage the expansion of reporting additional measures, it is essential that safe harbor rules be strengthened to specifically encompass the additional reporting.

- Develop and complement Web-based financial reporting
  - Internet delivery of hierarchical financial reporting that employs scorecards, current key performance indicators and analytical tools offering differing accounting standards is the future. Industry, users and the SEC should move ahead aggressively to develop models of such reporting frameworks without reducing access for investors in the short term.
  - Mandatory Internet access to financial reports — public companies should make the information available on their Web sites concurrent with SEC filings.
  - Voluntary business performance reporting, discussed above, may be more easily implemented through Web-based reporting.

- Expanded use of reports on Form 8-K
  - Items typically included in these filings could be expanded; however, the SEC's revised guidance should be "principle-based" and the current list of additional items to be disclosed should be presented only as "examples."

- Enhance filing requirements for foreign filers
  - Many foreign filers currently provide quarterly financial statements on a voluntary basis. FEI recommends that the SEC require foreign filers to file quarterly.

- Assess transition impact on paper documents
  - FEI does not suggest that hard copy mailings be eliminated in the near term. However, the content of paper mailings to shareholders should be examined to determine what modifications can be made and over what timeframe.
  - Financial disclosure to shareholders via paper documents has vastly exceeded a user's ability to digest it. The availability of public filings on the Web and analysis of information accessed by users should assist in identifying what is considered important. The resulting information could serve as a basis to expand the disclosures most often accessed and reduce those disclosures that are of little or no interest. This should improve understanding and communication while reducing costs to corporations and, ultimately, to the shareholders.

Improving Corporate Governance and the Effectiveness of Audit Committees

Recommendation 9: Effective implementation of the 1999 Blue Ribbon Panel Recommendations re audit committee financial experts.

In 1999, the *Blue Ribbon Panel on Audit Committee Effectiveness* called for all audit committee members to be financially literate and for each committee to have at least one financial expert.

FEI recommends that the NYSE and the NASDAQ set **higher standards** for audit committee "financial experts." These criteria should call for explicit experience requirements in the credentials of such experts. A financial expert should possess:

- An understanding of Generally Accepted Accounting Principles (GAAP) and audits of financial statements prepared under those principles. Such understanding may have been obtained either through education or experience. We believe it is important for someone on the audit committee to have a working knowledge of those principles and standards.

- Experience in the preparation and/or the auditing of financial statements of a company of similar size, scope and complexity as the company on whose board the committee member serves. The experience would generally be as a chief financial officer, chief accounting officer, controller or auditor of a similar entity. This background will provide a necessary understanding of the transactional and operational environment that produces the issuer's financial statements. It will also bring an understanding of what is involved in appropriate accounting estimates, accruals, reserve provisions, etc., and an appreciation of what is necessary to maintain a good internal control environment.

- Experience in the internal governance and procedure of audit committees, obtained either as an audit committee member, a senior corporate manager responsible for answering to the audit committee or an external auditor responsible for reporting on the execution and results of annual audits.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

Recommendation 10: Continuing professional education for audit committee members.

FEI recommends that all audit committee members attend continuing education in areas of financial reporting, risk management and/or accounting. Training can be "in-house" or via an outside provider. FEI, the National Association of Corporate Directors or an equivalent entity should establish the minimum content to be covered. Companies should disclose in the annual audit committee report whether members have undertaken such training. Non-audit committee directors are also urged to attend these sessions.

Recommendation 11: Periodic consideration of audit committee chair rotation.

FEI recommends that boards of directors periodically evaluate the need to rotate the individual holding the audit committee chair. Such evaluation may be done approximately every five years. FEI recognizes that outstanding audit committee chairs are valuable and difficult to replace. Yet there is also benefit in developing successors and additional financial experts on the audit committee. Therefore, rotation and successor development may further strengthen the overall governance mechanisms within the board.

Recommendation 12: Disclosure of corporate governance practices.

FEI recommends that all companies annually report their key corporate governance practices. Current best practice in many companies is to have a governance and nominating committee made up of independent directors.

Closing

FEI formed a task force of members to assemble this set of recommendations. The task force also had significant input from FEI's Committee on Corporate Reporting. These recommendations were then reviewed and approved by FEI's Executive Committee led by FEI Chairman David Young, CFO of Adaptec, Inc., and FEI Vice Chairman Ridge A. Braunschweig, CFO of Orion Corporation. FEI wishes to acknowledge and thank those involved in the preparation of this report.

<u>Task Force Members</u>

Philip D. Ameen
General Electric Company
Vice President and Comptroller

Scott M. Boggs
Microsoft Corporation
Vice President and Corp. Controller

Fred Corrado
The Great Atlantic & Pacific Tea Co., Inc.
Retired Vice Chairman & CFO

John P. Jessup
E.I. du Pont de Nemours & Company
VP Finance and Controller

Dennis D. Powell
Cisco Systems, Inc.
Vice President and Corporate Controller

Bryan R. Roub
Harris Corporation
Senior Vice President and Chief Financial Officer

David H. Sidwell
J.P. Morgan Chase & Co.
Chief Financial Officer - Investment Bank

Peter R. Bible
General Motors Corporation
Chief Accounting Officer

Frank J. Borelli
Marsh & McLennan Companies
Retired CFO

David J. FitzPatrick
United Technologies Corp.
SVP and Chief Financial Officer

Philip B. Livingston
Financial Executives International
President and CEO

J. Pedro Reinhard
Dow Chemical
EVP and Chief Financial Officer

David L. Shedlarz
Pfizer, Inc.
EVP and Chief Financial Officer

APPENDIX A: Code of Ethics of Financial Executives International

FEI CODE OF ETHICS

FEI's mission includes significant efforts to promote ethical conduct in the practice of financial management throughout the world. Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected and preserved. This Code provides principles to which members are expected to adhere and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public and other stakeholders. Violations of FEI's Code of Ethics may subject the member to censure, suspension or expulsion under procedural rules adopted by FEI's Board of Directors.

All members of FEI will:

- ✓ Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.
- ✓ Provide constituents with information that is accurate, complete, objective, relevant, timely and understandable.
- ✓ Comply with rules and regulations of federal, state, provincial and local governments, and other appropriate private and public regulatory agencies.
- ✓ Act in good faith, responsibly, with due care, competence and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.
- ✓ Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.
- ✓ Share knowledge and maintain skills important and relevant to constituents' needs.
- ✓ Proactively promote ethical behavior as a responsible partner among peers, in the work environment and the community.
- ✓ Achieve responsible use of and control over all assets and resources employed or entrusted.

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ATTACHMENT K

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

November 15, 1995

The Honorable Alfonse M. D'Amato
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

As we approach the end of the long road traveled on securities litigation reform, you have asked that we provide our views of the current draft of the legislation. At the outset, let us express our appreciation for your willingness to heed the concerns of the Commission regarding the draft conference report dated October 23, 1995. Together we have sought to achieve the most responsible reform possible.

While the Commission has raised a number of concerns about earlier versions of this legislation, we believe the draft conference report dated November 9th responds to our principal concerns. We understand the need for a greater flow of useful information to investors and the markets and we share your desire to protect companies and their shareholders from the costs of frivolous litigation.

The safe harbor provisions of the draft bills have been of particular interest to us. While we could not support earlier attempts at a safe harbor compromise, the current version represents a workable balance that we can support since it should encourage companies to provide valuable forward-looking information to investors while, at the same time, it limits the opportunity for abuse. The need of legitimate businesses to have a mechanism for early dismissal of frivolous lawsuits argues in favor of the codification of the "bespeaks caution" doctrine that has developed under the case law. While the trade-off requires that class action attorneys must have well written and carefully researched pleadings at the outset of the lawsuit, we feel this is necessary to create a viable safe harbor, given that it does not prevent Commission enforcement actions, and excludes the greatest opportunities for harm to investors.

Outside of the safe harbor provisions, we have consistently advocated reversal of Supreme Court decisions of Lampf and Central Bank. It is unfortunate that Congress has not restored these investor protections that were removed by the Supreme Court; however, we recognize that amendments on both subjects were defeated in the course of this legislative effort, thereby making it difficult to include such provisions in this bill. The conference bill

The Honorable Alfonse M. D'Amato
November 15, 1995
Page 2

raises other minor issues, but the language in the conference report hopefully will prevent any unintended consequences. We remain grateful to you and your staff, as well as the other members and their staffs, for the willingness to engage in a dialogue with us aimed at getting a better deal for all investors.

Thank you for your consideration.

Sincerely,

Arthur Levitt
Chairman

Steven M. H. Wallman
Commissioner

ATTACHMENT L

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHIEF ACCOUNTANT

February 13, 2002

VIA FACSIMILE

Mr. James S. Gerson, Chair
Auditing Standards Board
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10021

Dear Jim:

Recent events have raised questions about auditors' roles in helping to structure transactions in order to achieve a particular financial statement result. I believe that the Auditing Standards Board ("ASB") should take a leadership role with respect to these questions, and I believe that the first step in that process should involve an amendment of Statement on Auditing Standards No. 50 ("SAS 50"), Reports on the Application of Accounting Principles, to prohibit the issuance of a written report to intermediaries on the application of accounting principles not involving facts or circumstances of a particular principal (referred to as "hypothetical transactions" in SAS 50).

I believe that SAS 50, which was issued in July 1986, has improved practices in situations when the reporting accountant's opinion on the application of accounting principles takes into account both the vagaries of the accounting principles being considered and the particular facts and circumstances of the company that will apply the principles ("the principal"). This is in no small part because SAS 50 requires, in these circumstances (and circumstances where the report is issued to an intermediary acting for a principal whose identity is known), consultation with the continuing accountant (i.e., the auditor) of the principal prior to issuance of the report by the reporting accountant. As a result of this consultation, the reporting accountant is able to ascertain all the available facts relevant to forming a professional judgment, including information that otherwise might not be available.

In contrast, an accountant reporting on a hypothetical transaction knows only the information presented by the intermediary—a description of the transaction and, generally, the desired financial statement impact. There is no way for the reporting accountant to know, for example, whether the continuing accountant of the ultimate principal(s) has reached a different conclusion on the application of accounting principles to the same or a similar transaction, or how the ultimate principal(s) has accounted for similar transactions in the past. Therefore, the use of SAS 50 reports in this context, more often than not, does not contribute to high quality financial reporting.

The difference between the two types of situations is very significant and is exacerbated by the fact that many existing accounting standards are based on a highly prescriptive, rules based approach. I urge the ASB to expeditiously amend SAS 50 to prohibit the use of SAS 50 reports in situations that involve "hypothetical transactions."

Sincerely,

Robert K. Herdman

Robert K. Herdman
Chief Accountant

signed by
RJP-S

cc: Alan Anderson, Executive Vice President
American Institute of Certified Public Accountants

Edmund Jenkins, Chairman
Financial Accounting Standards Board

Robert Kueppers, Chairman
SECPS Executive Committee

Jerry Sullivan, Executive Director
Public Oversight Board

The Washington Post

November 15, 2000, Wednesday, Final Edition

The Securities and Exchange Commission yesterday announced a compromise with the accounting industry over a controversial auditor independence rule that Chairman Arthur Levitt Jr. has been pushing to get enacted before the end of the Clinton administration.

The agreement, worked out in private meetings with major accounting firms in recent weeks, will impose more restrictions on the services that auditors can offer. But the SEC has backed off from a proposal, heatedly opposed by three major accounting firms, to ban accountants from selling lucrative information technology services to their audit clients.

The deal is expected to avert a legal showdown between the SEC and opponents. The commission is scheduled to vote on the rule today.

Levitt, who has been personally involved in the negotiations, said "I feel very positive" about the compromise. He has argued that auditors can't be independent fiscal watchdogs if they are business advisers to companies. He has warned that large consulting fees might tempt the accountants to ignore problems in company books.

Though the SEC dropped its proposed ban on information technology consulting, Levitt said, "We got something I think is better, with the requirement for audit committee approval and disclosure."

SEC officials said that four of the Big Five accounting firms--PricewaterhouseCoopers, Ernst & Young, Arthur Andersen and Deloitte & Touche--agreed to support the rule. KPMG did not. The first two firms generally have supported the SEC's efforts, although they recommended changes. The other three firms have strongly opposed the effort for months.

Last night, William F. Ezzell, a partner with Deloitte & Touche, said the "concepts" of the compromise "sound reasonable, but we haven't seen any language at all. So until we see the language it's difficult to say we're there." Officials at Arthur Andersen declined comment.

Stephen E. Allis, a partner with KPMG, said the firm had not decided whether to continue opposing the proposal since it has not seen the details of the compromise.

The three firms had persuaded numerous members of Congress to pressure the SEC to delay action and also threatened a lawsuit if the rule was passed.

Opponents were particularly upset over two issues. The SEC's original proposal prohibited accounting firms from offering information technology services to their audit clients. Those services are lucrative, sometimes bringing in millions of dollars in revenue.

The accounting firms argued that the SEC had not justified the proposed ban. In fact, they argued that the large computer projects and other consulting work improve audits because they help them learn more about the company.

Under the compromise, the accounting firms can continue to design information technology systems for audit clients. But in return, as Levitt noted, the client must disclose in the annual proxy the total amount it paid to the auditor for information technology services. The client must also verify that the company's audit committee has considered whether the consulting services have hurt its auditors' independence.

The audited company, not the accounting firm, must control the information technology system.

The SEC also agreed to limit its so-called appearance standard to say that an accountant's independence would be considered impaired if a "reasonable investor" concluded the auditor couldn't act without bias.

In all, the SEC issued restrictions on nine services--seven of which were already restricted by American Institute of Certified Public Accountants rules or SEC guidelines. The rule will codify those restrictions.

Companies must disclose in their annual proxy statements the fees for audit, information technology, consulting and all other services provided by their auditor during the last fiscal year.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 23, 2002

The Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairmen Sarbanes and Oxley:

I am writing regarding the foreign audit workpapers provision of the proposed "Public Company Accounting Reform and Investor Protection Act." Although it has received little attention, I believe the provision is critical to our enforcement efforts, and I wish to express my strong support for its inclusion in the final legislation.

As you know, the foreign audit workpapers provision is intended to provide an effective mechanism for the SEC to obtain relevant audit workpapers from accounting firms abroad. Such a tool would greatly facilitate the SEC's efforts to investigate and prosecute financial fraud, and is distinct from the auditor oversight provisions of the bill.

In today's global economy, many U.S.-listed companies maintain operations in foreign countries and report significant revenues generated by such operations. U.S. companies' foreign operations and foreign revenues typically are audited by foreign accounting firms, including foreign affiliates of U.S. accounting firms. Workpapers from these audits may contain information invaluable in uncovering a financial fraud, including providing evidence of who engaged in or was aware of misconduct. Further contributing to the need for access to foreign accounting firms' workpapers is the growth in the number of foreign private issuers listed in the U.S. At the end of 2001, there were 1,344 foreign private issuers reporting to the Commission, most of which engaged foreign auditors.

Although an auditor's workpapers are important records in any financial fraud investigation, the Commission has had limited success in gaining access to work performed by non-U.S. auditors, even when those foreign auditors have chosen to affiliate with U.S.

accounting firms. The Commission lacks explicit authority to serve investigative subpoenas outside of the U.S., even on a foreign accounting firm that audited financial statements filed with the Commission. Due to this limitation, the SEC has sought to obtain documents from foreign auditors by serving subpoenas on affiliated U.S. audit firms, placing border watches on individual foreign auditors in the hopes of serving process, or relying on information sharing arrangements with our regulatory counterparts overseas. These strategies have consistently proven cumbersome, however: U.S. audit firms typically contest the reach of subpoenas served on them, contending that U.S. firms are distinct from their foreign affiliates (even though the foreign affiliates and the U.S. firms share name and other co-branding and marketing arrangements); and border watches are slow and unwieldy. As for information sharing arrangements, the Commission has such arrangements with only a minority of foreign countries, and even where they exist, the prescribed procedures can make information gathering difficult and time-consuming.

In short, if the foreign audit workpapers provision were enacted as part of your bill, it would compel foreign auditors to provide the SEC with the audit documentation that U.S. auditors already are required to provide, and would provide the Commission a critical tool in the fight against accounting fraud.

Again, I express my sincere thanks for your leadership on these issues. Please do not hesitate to contact me if there is anything my staff or I can do to assist you as this process moves forward.

Sincerely,

Stephen M. Cutler
Director

cc: The Honorable Phil Gramm, Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate

The Honorable John J. LaFalce, Ranking Member
Committee on Financial Services
U.S. House of Representatives